The New York

Certified Public Accountant

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CURRENT EVENTS

Calendar of Events

March 18—Regular Meeting of the Board of Directors.

March 18—7:45 P.M.—Society Meeting—Subject: To be announced later. Location: Waldorf-Astoria Hotel, Lexington Avenue at 49th Street, New York City.

April 4—Regular Meeting of the Board of Directors.

April 8—7:45 P.M.—Society Meeting—Subject: To be announced later. Location: Waldorf-Astoria Hotel, Lexington Avenue at 49th Street, New York City.

Special Technical Meetings

A new series of six special technical meetings (formerly called round-table meetings), is scheduled for the Spring. All of the meetings will be held on Wednesday evenings at 8 P.M. in the Engineering Auditorium, 29 West 39th Street, New York City. The series will begin on April 3rd and will end on May 10th.

The following subjects will be taken up by committees at these meetings:

April 3rd—Intangible Assets—T. Reginald Cloake, Chairman.

April 10th—Real Estate Accounting—Allan C. George, Chairman.

April 17th—Mining and Smelting Accounting—Crawford C. Halsey, Chairman.

April 24th—Governmental Accounting—Everett J. Penny, Chairman.

May 1st—Dairy Industry Accounting—Chester W. DeMond, Chairman.

May 10th—Foreign Trade Accounting—George W. Price, Chairman.

Further notice will be sent to the members on the details of the meetings.

Announcement

The Pace Institute cordially invites the members of The New York State Society to attend a Forum Discussion of "Stock Brokerage Accounting under the New Regulations of the New York Stock Exchange" by Frederick S. Todman, a member of the Society, to be held on Thursday, February 15th, at 7:30 P.M. in Alumni Hall, 225 Broadway, New York City.

The subject matter to be covered will be related to the surprise element in examinations which is sponsored by the Exchange, reference to the prescribed audit procedure, the computation of "Aggregate Indebtedness" and "Net Capital" ratios and the preparation of condensed financial statements under direction of the Exchange.

Admission is by ticket only which may be obtained from Pace Institute. The number of tickets is necessarily limited to three per person.

Directory of Members Distributed

To meet the requests of bankers, credit men and trade associations and others interested, 9,000 copies of the Directory of Members of The New York State Society have been distributed this month.

The communications and telephone requests for copies of this publication indicate that it is constantly being used by the general public.

The Directory of Members is not

distributed to the membership of this Society as it is a reprint of the list of members, brought up to date, taken from the Year Book recently distributed to the members. Any member wishing a copy of the Directory may obtain same upon request.

January Society Meeting

Inventory Pricing was the subject of the January 8, 1940 meeting of the Society held at the Waldorf-Astoria Hotel. The meeting was conducted by the Committee on Cost Accounting of which Marshall Granger is chairman.

Arno R. Kassander, a member of the committee, spoke on "Last-in first-out Inventory Method", and Marshall Granger delivered an address on "Auditing Inventory Prices". Raymond P. Marple, Head of the Research and Service Department of the National Association of Cost Accountants, spoke on "Overhead Costs in Inventories", and Clarence Crocheron, President of the New York Chapter of the National Association of Cost Accountants, talked on "Inventory Valuation from an Appraisal Viewpoint". Dr. Stuart C. McLeod did not deliver a paper but participated in the program.

The papers delivered at this meeting and part of the discussion are contained in this issue of the publication.

Notice to Members

Frequently, the Society receives requests to furnish speakers to outside organizations such as trade associations, clubs, and schools to address their members on accounting and allied subjects.

In order to assist these organizations better in securing competent speakers, it would be appreciated if members of the Society who are willing and able to speak at meetings of this type, advise the office of the Society so that a list of speakers will be available.

Addition to the Staff

Upon the approval of the Board of Directors, Joseph W. Welsh, Jr., has joined the staff of the Society. Mr. Welsh will work mainly on public relations but will also give considerable time to the general organization work of the Society, assisting the Assistant to the President in that respect.

Mr. Welsh comes to the Society with a fine background of experience in public relations, credit and financial work.

Advancement Applications

The Committee on Admission announces that Society members, in the future, in applying for advancement to regular membership in the Society will be required to fill out a new advancement application form which brings their employment and educational qualifications up to date.

Society members on applying for advancement should secure a copy of this form from the office of the Society and return it with their request for advancement.

Practical Tax Courses

Three courses on taxation designed for accountants and lawyers engaged in tax practice will be conducted commencing in February by the Practicing Law Institute, a non-profit educational institution chartered by the Board of Regents of the University of the State of New York.

The first of these courses will be given on Monday evenings beginning February 19 and will deal with Tax Practice and Procedure. Howe P. Cochran, who gives the course,

takes up in detail during the 16 lectures, the practical technique to be employed in the various phases of typical tax cases and the practice and procedure in connection with them.

On Wednesday evenings commencing February 28, there will be an advanced course on Current Problems in Taxation covering thirteen subjects including trust problems, powers of appointment and the federal estate tax, discharge of indebtedness, regulations problems, improper accumulations of corporate surplus, stock dividends and stock rights, profit sharing annuity and pension plans, continuity of interest in corporate reorganizations, domicile, taxation of non-resident aliens and foreign corporations, life insurance and the income tax, and current trends in taxation.

For those who wish to become familiar with practice and procedure in handling social security and unemployment tax matters, there is a 12 lecture course to be given on Thursday evenings commencing February 29.

A booklet describing the courses in detail is issued by the Practising Law Institute, which has offices at 150 Broadway, New York City.

Recent Publications

Accounting Requirements of the S.E.C. (For the Preparation of Financial Statements). By B. Bernard Greidinger. The Ronald Press Company, New York, 1939. 517 pages, $5.

The purpose of this book is to give members of the accounting profession an understanding of the attitude of the Securities and Exchange Commission towards accounting procedure and principles. The author has achieved this end by making a careful study of both the deficient (rejected) and the amended (corrected) statements on file at the Commission. By analyzing the changes and amendments made by the Commission in specific cases, he has given a very clear picture as to the Commission's accounting requirements for the preparation of financial reports.

The book is lengthy in scope and contains many detailed analyses and comparisons of the amended statements. It contains seven chapters pertaining to the requirements as specified by the Commission for the preparation of a balance sheet, two chapters on profit and loss statements, and three chapters involving a discussion of the requirements for preparing accountants' certificates. In many cases excellent illustrations are given of the pitfalls to be avoided in the preparation of accounts so as to have these conform with the principles as laid down by the Commission.

The book should be of real assistance to public accountants and teachers of accounting courses, particularly as the control exerted by the Securities and Exchange Commission has now become one of the most pressing and important phases of accounting practice.

Manual of Teachers College Accounting. By Edward V. Miles, Jr. American Council on Education, Washington, D.C., 1940. $2.50.

This is a companion volume to Financial Reports for Colleges and Universities by the National Committee on Standard Reports for Institutions of Higher Education, and to the Accounting Manual for Colleges. The development of the manual grew out of a need for uniform accounting in teacher colleges. The American Association of Teachers Colleges appointed a committee to cooperate with the Financial Advisory Service of the American Council on Education in the preparation of this work.

The present volume was prepared with the purpose in mind of assisting not only the teachers college, but also to serve as a guide to liberal arts colleges and other institutions of higher education. It reviews briefly the fundamental principles of college accounting. It begins by analyzing the accounting system and establishing a chart of accounts. From this point budgetary control is explained in its relation to the accounting system. An accounting system is then developed in great detail, beginning with the general ledger, and all necessary records and forms are brought into the discussion. A complete set of financial statements is also presented. The book presents a complete plan for coordinating the budget, the accounting system, and the financial statements.

This book should prove invaluable as a reference work for all college business officers. To those who are new in this field of work it will prove indispensable. Employees of college business offices who are anxious to improve themselves as well as their work will find this an exceptionally valuable volume.

Accounting Release of the Securities and Exchange Commission

Continuing the series of accounting releases by the Securities and Exchange Commission as published in the October, 1938 and January, 1939 issues of the Bulletin, the following release No. 11 issued by the Securities and Exchange Commission is printed here for the information of the members:

January 4, 1940

ACCOUNTING SERIES
Release No. 11

The Securities and Exchange Commission today announced the issuance of an additional opinion in its accounting series, dealing with the problem of inclusion and exclusion in consolidation of foreign subsidiaries of domestic corporations. The opinion, prepared by William W. Werntz, Chief Accountant, in response to an inquiry, follows:

"Inquiry has been made as to the propriety of including in consolidation with domestic corporations foreign subsidiaries whose operations are effected in terms of restricted foreign currencies, or whose assets and operations are endangered by the war conditions prevailing abroad.

"Foreign currency restrictions and war conditions are of such significance with respect to subsidiaries operating in affected territories as to require, in my opinion, that registrants consider carefully their policy with respect to the inclusion of such subsidiaries in consolidated financial statements. It is my opinion in general that the consolidation of such foreign subsidiaries with the domestic parent and other domestic or foreign subsidiaries may be misleading. However, if notwithstanding the existence of exchange restrictions and war conditions affecting certain foreign subsidiaries at the time the financial statements are prepared, the inclusion of such foreign subsidiaries in the consolidated statements is considered desirable and in the particular case will not prevent a clear and fair presentation of the financial condition and the results of operations of the registrant and its subsidiaries, their inclusion is ordinarily permissible. If included, however, disclosure should be made as to the effect, in so far as this can be reasonably determined, of foreign exchange restrictions and war conditions upon the consolidated financial position and operating results of the registrant and its subsidiaries.

"In any case, the existence of currency restrictions and war conditions requires that careful consideration

should also be given to the question of providing, and, if provision appears necessary, the extent of such provision, for impairment of the registrant's investment in such foreign subsidiaries by reason of the prevailing conditions and losses suffered by such subsidiaries."

Arthur W. Teele

Arthur W. Teele, a partner of the firm of Patterson, Teele & Dennis, 120 Broadway, New York City, died suddenly on January 30th.

Mr. Teele was a charter member of this Society, having been admitted to membership in March, 1897, and became its Secretary at that time and served as such until May 8, 1899. In November 1902 Mr. Teele became a Society Fellow of the American Association (predecessor of AIA) through the New York State Society. He was a member of the State Board of C.P.A. Examiners from September 1905 to December 1907. Mr. Teele was also the Treasurer of the American Institute of Accountants.

He is survived by his widow.

In his death, this Society as well as the accountancy profession at large, has sustained the loss of an able and loyal member whose long record of devotion to the profession has contributed much and has exerted an influence which will long survive him.

ELECTIONS

THE following is a list of applicants admitted to membership and associate membership in the Society and also associate members advanced to membership at a meeting of the Board of Directors held on January 4, 1940:

Membership

Francis I. Bertsch, 744 Broad Street, Newark, N. J.,
With Haskins & Sells.
Edward H. Braunstein, 132 Nassau Street,
With Irving J. Fallick.
Herman J. Dobkin, 25 West 43rd Street,
Of Hurwitz, Miller & Dobkin.
Arthur William Falk, 30 Broad Street.
Hugh L. Flanigan, 13 Birch Street, New Rochelle.
Robert M. Ginzler, 949 Broadway,
With Meyer Parmet.
Morris A. Greenbaum, 401 Broadway.
Irwin Grundman, 60 East 42nd Street.
Irving B. Katz, 103 Park Avenue,
Of Abraham Solomon & Company.
Flora F. Kaufman, 521 Fifth Avenue.
Harold Kornfeld, 295 Madison Avenue,
With L. B. Prosnitz & Co.
Louis Lacher, 90-50 Parsons Boulevard, Jamaica,
Of Spahr, Lacher & Spahr.
Joseph Loutit, 80 Maiden Lane,
With Touche, Niven & Co.
Benjamin Oringel, 1476 Broadway.
Milton J. Popper, 501 Fifth Avenue,
Of Milton J. Popper & Co.
Arthur Norman Raymond, 56 Pine Street,
With Price, Waterhouse & Co.
Paul Safro, 220 Fifth Avenue.
Maxwell Joseph Santman, 1451 Broadway.
Ellen Marion Sarafen, 304 Trust Company Bldg., Watertown,
With Howard F. Farrington.
Morris L. Schuster, 114 East 32nd Street.
Moses Stein, 1450 Broadway,
Of Samuel Negin & Co.
John Cyrus Wilson, 25 Broadway,
With Pogson, Peloubet & Co.
Harry S. Wittner, 156 East 46th Street.
Hans Zysman, 299 Broadway.

Associate Membership

Leonard A. Andriuzzi, 418 Grand Street, Paterson, N. J.,
With The Linen Thread Co. Inc.
Moses Master, Federal Bldg., Louisville, Ky.,
With Internal Revenue Bureau, Income Tax Unit.

Charles Rinderle, Jr., 754 Lexington Avenue, Brooklyn,
With Bendix Aviation Corporation-Marine Division.
Harry Schaeffer, 320 Schermerhorn Street, Brooklyn,
With N. Y. State Dept. of Taxation & Finance.
Leo Sternfeld, 80 Broad Street,
With Seidman & Seidman.
Frank S. Turbett, Jr., 19 Rector Street,
With Ernst & Ernst.
Charles F. Werber, Jr., 32 Broadway,
With Charles F. Werber, Sr.

Advancement from Associate Membership to Membership

Max Birsch, 1450 Broadway,
With A. M. Brauer & Co.
Harry Borow, 320 Fifth Avenue,
Of Borow & Borow.
Carl Brandon, 225 Broadway,
Of Brandon & Brandon.
Herbert J. Brown, 90 Broad Street,
With Lybrand, Ross Bros. & Montgomery.
Harold C. Chinlund, 90 Broad Street,
With Lybrand, Ross Bros. & Montgomery.
James Theodore Ellis, 25 Monroe Place, Brooklyn.
James B. Fish, Jr., 90 Broad Street,
With Lybrand, Ross Bros. & Montgomery.
Carl H. Forsberg, 350 Madison Avenue,
With Hurdman & Cranstoun.
Douglas Frank Hampson, 18 East 48th Street,
With Harris, Kerr, Forster & Company.
Theodore R. Jarvis, 120 West 42nd Street.
Sidney B. Kramer, 270 Broadway,
With Louis Kramer.
Herbert Lazarus, Putnam, Conn.,
With Edmar Footwear Co.
Stanley Meisel, 17 Academy Street, Newark, N. J.,
With Geltzeiler & Meisel.
Willard J. F. Murphy, 405 Lexington Avenue,
With Seagram-Distillers Corp.
Frederick John Otterbein, 56 Pine Street,
With Price, Waterhouse & Co.
Alfred Byron Reiss, 230 Park Avenue,
With Allen R. Smart & Co.
Morris Schneider, 260 West 41st Street.
Herman A. Spiegel, 286 Fifth Avenue.
Rudolph Steiner, 11 West 42nd Street,
Of Steiner & Company.
Stiles William Stevens, 10 East 40th Street,
With Martin Kortjohn & Company.
Kenneth G. Van Sciver, 15 Vanderburgh Avenue, Larchmont.
E. Paul Venneman, 1720 Rand Bldg., Buffalo,
With Price, Waterhouse & Co.
Joseph E. Vinck, 56 Pine Street,
With Price, Waterhouse & Co.
Herman Volk, 551 Fifth Avenue.
William H. Weber, 22 East 40th Street,
With Haskins & Sells.
Arthur B. West, 149 Broadway,
With The Singer Manufacturing Company.

The number of members in the Society as of January 31, 1940, is as follows:

Members	3,149
Associate Members.	391
Total.........	3,540

Overhead Costs in Inventories

By Raymond P. Marple

THE valuation of goods-in-process, finished parts and finished goods inventories brings the auditor face to face with cost accounting. While most public accountants have been trained in cost accounting, their approach to costs is often quite different from that of the cost accountant. This is understandable when one considers the different points of view which each brings to his work. The viewpoint of the public accountant is external. He is primarily concerned with the financial reports and with the pictures of condition and progress which they present to stockholders, bankers and the general public. On the other hand, the viewpoint of the cost or industrial accountant is internal. He is primarily concerned with accounting as a management tool. While the costs which he compiles are used for valuing inventories, they are also used in pricing and as a basis for cost control. Often there must be a compromise between the methods best suited to the valuation of inventories and those which give best results for pricing or the control of costs.

Fortunately, this difference in primary viewpoint has not blinded either the public accountant or the cost accountant to the problems of the other. Public accountants today are more alive to the management problems involved in accounting than ever before. At the same time cost accountants are becoming more financial-statement conscious and are finding ways and means of attaining the ends desired and needed by management without running counter to good financial accounting practice. The very fact that the New York State Society of Certified Public Accountants has set aside part of one of its monthly meetings for a consideration of cost accounting as involved in the pricing of inventories is indicative of the interest which cost and public accountants have in each others problems.

In discussing the subject assigned me, "Overhead Costs in Inventories," I hope you will be indulgent if what I have to say seems at times rather elementary. Apparent differences of opinion often arise through misunderstanding of terms and, since the terminology of overhead costing is far from standardized and may at times be misleading, I shall need to devote some time to what might be considered elementary concepts.

To begin with, we are concerned only with the overhead costs of manufacturing, which are usually referred to as burden, manufacturing expenses or simply "overhead." We are not concerned with selling and administrative overheads, since these are not normally included in inventory values. The overhead costs which we are to consider include all of the costs of manufacturing other than direct material and direct labor.

The expenses making up manufacturing overhead are of two kinds, variable and fixed. A variable expense is one which varies directly with the activity giving rise to it, while a fixed expense is one which remains constant in amount over a wide range of activity. In addition to fixed and variable expenses, there are expenses of the semi-variable type, which vary in total amount

Presented at the January 8, 1940 Meeting of The New York State Society of Certified Public Accountants.

with variations in the activities giving rise to them, but do not vary in direct proportion. These semi-variable expenses are merely combinations of fixed and variable elements in one figure, and by careful study the two elements can be separated.

Perhaps by now you may have decided that I am already off the track and am starting to discuss overhead control rather than overhead application for valuation purposes. But let me correct any such impression by emphasizing that the treatment of fixed expenses is, in my opinion, the crux of the inventory valuation problem so far as overhead is concerned. Most of the really difficult problems of overhead application arise because of fixed expenses. Because these expenses do not vary as the volume of production changes, the cost of overhead per unit of product or per machine or direct labor hour tends to vary inversely with the volume of production. This results in low overhead costs per unit of product in periods of more than normal activity, when selling prices are usually high, and in high overhead costs per unit of product in periods of low activity, when selling prices are likely to be low. Product costs obtained by including overhead on this basis are as unsatisfactory for inventory valuation purposes as they are for the determination of selling prices or the calculation of profits.

Now, let us take a moment to consider the nature of these fixed expenses. Most of them are related very closely to what we call plant or productive capacity. A plant is constructed and equipped with the idea of producing a certain quantity of product. Whether that productive capacity is utilized or not, depreciation, taxes, insurance and similar expenses will continue year after year. Other fixed costs are largely in the form of salaries of operating personnel. In any manufacturing company there will be a group of key men, whose services will need to be retained so long as the plant operates, no matter what the volume of production. Still other fixed costs are those arising from certain service functions such as watchmen, janitors, etc. These costs continue so long as the plant operates.

Let us assume that a manufacturing plant has the productive capacity to manufacture 1,000,000 units of product a year. So long as this productive capacity is utilized, it is entirely logical that the costs arising from it should be charged against the units produced. But suppose only 50 per cent of this productive capacity is utilized. Is it still proper to charge the units produced with the total fixed costs of the plant? To do so will mean that the half-million units produced will be charged not only for the capacity which was utilized in their production, but also with the fixed costs of the unutilized capacity. The result will be that production will be charged for costs for which it was not responsible and unit product costs will be much higher than when the plant is producing 1,000,000 units.

To emphasize this point, let me state it in another way. Suppose a company operates two plants, each capable of producing 500,000 units of product annually. Let us assume that due to reduced sales demand to only 500,000 units per year, it is decided to close one plant. Would it be logical in this case to load on to the production of the operating plant all of the depreciation, taxes, insurance, and other fixed costs of the plant which is closed down? Certainly the closed plant contributes nothing to the goods produced or in any way enhances their value. The only difference between this case and the previous case is that

in one case the productive capacity is divided between two plants while in the other it is all in one plant. In each case only one-half of the productive capacity is being utilized when production is at the 500,000 unit level, and logically only one-half of the fixed costs of productive capacity should be charged to the goods produced.

The method used by the cost accountant for excluding the fixed cost of unutilized capacity from product costs is the application of overhead by the use of normal capacity rates. This can be illustrated by assuming that a plant has a total fixed cost of $150,000 per year, and that the variable overhead costs amount to 50¢ per direct labor hour. Without for the moment defining what is meant by normal capacity, let us assume that for this plant the normal capacity has been placed at 200,000 direct labor hours per year. To arrive at a normal rate for the application of overhead, it is merely necessary to add to the 50¢ per hour variable costs, the hourly rate for fixed overhead which is obtained by dividing the fixed costs by the direct labor hours at normal capacity. Fixed costs of $150,000 divided by 200,000 hours gives us a fixed cost of 75¢ per hour to add to the 50¢ variable cost. If production volume is at normal, all of the overhead will be applied to products by the use of the rate of $1.25. But if production is below normal, say at the rate of 100,000 direct labor hours per year, the use of this normal burden rate will result in the application of all variable overhead (which will have dropped in the same ratio as production) but only one-half the fixed costs which will have remained unchanged while production has been halved. The unapplied or unabsorbed balance of $75,000 will represent the fixed costs applicable to the unutilized portion of the plant capacity.

Now, just what do we mean by *normal* capacity. Naturally we do not mean the maximum theoretical capacity of the plant, for no plant can be expected to operate without allowances for unavoidable interruptions such as time lost for repairs, machine set-ups, waits for material, machine failures, organization slips and similar losses of operating time. Neither do we mean the potential operating capacity of the plant after proper allowances have been made for these interruptions to operations. Rather by normal capacity we mean that "utilization of the plant that is necessary to meet the *average* commercial demands over a period long enough to level out the peaks and valleys which come with seasonal and cyclical variations." This definition of normal capacity is taken from an article in the N. A. C. A. Bulletin for December 1, 1934, written by Charles C. James, who goes on to point out that normal capacity or normal utilization of the plant will always be less than potential operating capacity "because every slowing down in demand which lasts long enough to reduce operations below the practical maximum would have the effect of bringing the average below the practical maximum."

We all know that in every business there are seasonal and cyclical influences which result in great variations in production. In order to average a monthly production of 100,000 units, it may be necessary for the manufacturer to have a plant capacity capable of producing a maximum of 150,000 units a month. The point to keep in mind is that the plant is constructed to make possible an average production of 100,000 units per month, and that this is possible only if the capacity is available to produce 150,000 units during peak periods. Obviously, if the plant is

designed for the production of 100,000 units, the fixed costs of that capacity should be charged to products on the basis of a normal capacity of 100,000 units.

But conditions change and original estimates are later proven in error. A plant constructed to produce 100,000 units may in time come to have a demand for only 60,000 units of product, and never have a peak demand in excess of 90,000 units. In such a case, there is excess capacity which it appears will never be utilized. Good financial management and good accounting demand that the costs connected with this excess capacity be segregated and none of them included in production costs. But we are not concerned here with excess capacity. We are talking about a plant which is not overbuilt or overequipped, but which, in order to meet peak demands, has a greater potential operating capacity than is required to meet average or normal commercial demands. In such a plant all of the fixed costs should be absorbed when the plant operates at normal capacity. When operations are below normal, there will be an underabsorption of burden, while greater than normal operations will result in the overabsorption of burden.

What I have said up to this point is largely theory, and, I believe, good theory. Now let us take a look at actual practice. In 1938, the Research Department of the National Association of Cost Accountants made a questionnaire survey of "Practice in Applying Overhead and Calculating Normal Capacity." One of the questions asked in that study was, "Do you calculate burden rates by dividing estimated expenses by (1) estimated production or activity for the period or (2) estimated normal capacity?" Of 194 companies whose practices were indicated by answers to this question, 67 based burden rates on estimated production for the period, while 127 companies based their rates on normal capacity.

Why, if cost accountants believe in the application of burden by the use of rates based on normal capacity, do one-third of the companies covered in this study use rates based on estimated production? Perhaps this question might be answered in the same way as another question: "With the fundamentals of a good golf stroke so well known, why are there so many poor golfers?" As any golfer learns early, it is one thing to know how a stroke should be made, and it is something quite different to put that knowledge into practice. In my opinion the same sort of reason explains why there has not been a more general application of the theory of normal overhead. Anyone who attempts to say what is normal for a company in these days of rapid change is accepting considerable responsibility. It is much easier and safer to restrict one's forecasting to the year immediately ahead. Possibly for some industries of the consumer goods type, burden applied on such forecasts may give results approximating those under normal burden rates.

Involved in the subject of normal overhead is the question of the proper disposition of over- and under-absorbed burden. If overhead is applied at rates based on normal capacity, what disposition should be made of the unapplied balance when operations are below normal, and what should be done with the credit balance resulting from the application to products of more overhead than is actually incurred when operations are above normal. In a questionnaire study of "Finished Goods Inventory Practice" by the Research Department of N. A. C. A. which has not yet been published,

some information on current practice in this field was obtained.

Let us consider underapplied overhead first. Of 210 companies whose practices were reported, 134 treated unabsorbed burden as a charge to cost of goods sold, 58 as a charge to profit and loss, 8 as an amount to be pro-rated between cost of goods sold and inventories and 10 as an amount to be deferred or charged against overabsorbed balances of past years.

Turning now to overabsorbed balances, with 208 companies reporting, we find 124 crediting cost of goods sold for the overabsorbed balance, 56 crediting profit and loss, 19 prorating the overabsorbed balance between cost of sales and inventories, and 9 treating the overabsorbed amount as a reserve against which future underabsorption may be charged.

It is interesting to speculate on the theories of overhead application which underlie this sample of practice. Apparently very few companies are swayed by the argument that the application of overhead on the basis of normal capacity rates results in the underabsorbed balances of one period being offset by overabsorption in other periods, since only 10 companies defer unabsorbed overhead and only 9 companies treat an overabsorbed balance as a reserve. Conditions change too rapidly and accurate estimating is too difficult to make this method of handling the balances practical.

As previously reported, many companies base burden rates on expected production for the period for which the burden rates apply. Where this is done, any debit or credit balance at the end of the year represents an error in either the estimated volume of production or the estimated total overhead expenses. Since the object is to apply all overhead of the period to the production of the period, any balance logically represents an adjustment of cost of goods sold and goods-in-process and finished goods inventories. Yet only 8 companies prorate unabsorbed burden between cost of goods sold and inventories, while 19 companies make the proration when the burden is overabsorbed.

The vast majority of companies charge or credit burden balances to either profit and loss or cost of goods sold. Those charging or crediting profit and loss apparently do so in the theory that the under- or over-absorbed balance results from variations in the volume of business which are not under the control of the manufacturing division of the business, and the resulting balances, therefore, are not manufacturing costs. But the largest group charge or credit cost of goods sold, apparently on the theory that, while the overhead should be applied to products on a normal capacity basis for inventory valuation and pricing purposes, any resulting balance is still a cost of the manufacturing department and therefore should be included in cost of goods sold.

Another problem very closely related to the one which we have been discussing is the disposition of variances from standard costs in companies operating under ideal or current standard cost systems. It is argued by some that while standard costs are proper and valuable for control purposes, they do not represent a proper basis for inventory valuation. However, of 131 companies using ideal standard costs and cooperating in the recent N. A. C. A. study of finished goods inventory practice, only 2 made any reference to prorating the variances between inventories and cost of goods sold. Of the others, 70 transfer the variances to cost of goods sold, 22 transfer them to profit and loss and the other 39 either did not reply to

this question or reported that their practices varied.

To me the surprising features of these summaries of practice are two: first, the general acceptance of standard costs for inventory valuation purposes as evidenced by the fact that of 131 companies only two report that inventories are adjusted for variations from standard costs, and, second, the relatively small number of companies which adjust inventories when burden is over-absorbed. Of course, it should be recognized that these companies were reporting only their usual or customary practice. Undoubtedly, in situations where the variances are so great as to reflect on the correctness of the standard costs or where over-absorbed balances are large in comparison with total costs, some adjustments of inventory values would be made. Certainly, the auditor should be on guard to see that any variances which are charged off, represent real variances from logical and proper standards and do not result in valuations which are materially out of line with costs calculated on an actual basis. By the same token, over-absorbed burden balances should receive the careful consideration of the auditor, since a substantial over-absorption may result in a considerable over-valuation of goods in process and finished goods.

The subject assigned me was "Overhead Costs in Inventories." I have commented on only one aspect of this subject, the use of normal capacity rates, largely because I feel that this is the most important and difficult feature of overhead costing. Other aspects of overhead application which the auditor will want to investigate are the methods used in apportioning service department costs, the departmentalization used for burden application purposes, the unit of activity used as a base for applying burden, and the treatment of certain costs on the border line between manufacturing, selling and administrative expenses.

The "Last-In, First-Out" Inventory Method

By Arno R. Kassander, C. P. A.

THE last-in, first-out method for determining costs and pricing inventories has gained recent prominence and become a matter of current interest. The American Petroleum Institute has adopted it as the standard for the petroleum industry. The special committee on inventories of the American Institute of Accountants gave careful consideration to the method as recommended by the American Petroleum Institute for use in its industry and found that it constitutes an acceptable method for those companies which, finding it adaptable to their needs and views as correctly reflecting their income, apply it consistently from year to year. The full report of the committee appears in the "Journal of Accountancy" for August, 1936.

Under the Revenue Act of 1938, tanners and producers and processors of non-ferrous metals were permitted to use the last-in, first-out inventory method with certain restrictions. The Revenue Act of 1939 extends this privilege to all taxpayers who satisfy the conditions prescribed in the statute, for taxable years beginning after December 31, 1938.

Purpose of Last-In, First-Out Method

The last-in, first-out method is predicated on the desire to avoid the recognition of profits which result from sales in a rising market of products obtained at relatively low cost and which are necessarily replaced at higher cost. It seeks to attain the objective through the use of procedures by means of which the costs of current purchases are applied to current sales; that is, costs of current sales are charged with raw materials at prices which most nearly correspond, in point of time, with those which will be paid to replace the materials consumed.

The last-in, first-out method is merely one method of determining costs and is to be considered, as to its usefulness, in comparison with other available methods such as first-in, first-out or average costs. The method assumes that current purchases are made for the purpose of replacing stocks used for current sales, and that consequently the current purchases should be charged against concurrent sales. This method obviously results in an inventory valued at the cost of the earliest acquisitions as contrasted with the first-in, first-out method under which the latest costs are reflected in the inventory.

It may be pointed out at this point that whereas the first-in, first-out method is based on an assumption (which may not be fact) that goods are used in the order of their acquisition, the last-in, first-out method in spite of its name is not based on the reverse assumption. In fact, this method makes no assumptions as to the order in which goods are consumed. The method merely assumes that current purchases are made for the purpose of replacing stocks used for current sales.

Theoretically, it is possible to use the method in any case in which either the first-in, first-out or average cost method could be used, including the valuation of finished goods. However, in some instances, the mechanics of its application may render its adoption impracticable or inadvisable.

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Effect upon Financial Statements and Tax Status Where Market is Lower Than Last-In, First-Out Cost

As previously stated, the last-in, first-out method is merely a method of determining costs and does not constitute a new fundamental accounting principle. Costs so determined may not correspond with prevailing market value and, where such market value is less than cost, for the purposes of the balance sheet an adjustment may be required if the inventory is to be described as having been priced on the basis of the lesser of cost or market value.

In contradistinction to the foregoing treatment of inventories, for the purposes of financial statements, however, in determining taxable income under the new law, if the last-in, first-out method is adopted the inventories must be priced at cost. The law does not permit for tax purposes the use of the lower of last-in, first-out cost or market. If the lower of cost or market is used, cost must be determined as heretofore on an identification basis or a first-in, first-out basis. However, a taxpayer may use the lower of (a) last-in, first-out cost, or (b) market for financial purposes, without sacrificing the right to use the last-in, first-out cost basis for tax purposes.

The prohibition against the use of market for tax purposes appears to be confined to current first-line merchandise and materials, for the regulations issued under the 1938 Act and prior acts (which will in all probability be continued under the 1939 Act) provide that even when inventories are taken at cost:

"Any goods in an inventory which are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or similar causes, including second-hand goods taken in exchange, should be valued at bona fide selling prices less direct cost of disposition . . ., or if such goods consist of raw materials or partly finished goods held for use or consumption, they shall be valued upon a reasonable basis, taking into consideration the usability and the condition of the goods, but in no case shall such value be less than the scrap value" . . . Art. 22 (c)—2; Reg. 101.

The prohibition of the use of market for tax purposes may in certain circumstances create still another instance of difference between "tax accounting" and "business accounting." However, if price declines result in unallowable losses, the taxpayer may console himself with the knowledge that future recovery in prices will not *ipso facto* create taxable income.

The possible conflicting concepts between the tax law and accepted accounting principles arising out of the use of the last-in, first-out method, as well as the effects on the income account inherent in its use, render it desirable that the method be initiated at such time as the price cycle is deemed to be at or near its low point and further when the inventory on hand was actually acquired at or near the low prices. The 1939 Act provides that goods (presumably of like kind) which were included in the opening inventory of the taxable year in which the last-in, first-out method is first used are to be treated as having been acquired at the same time and priced by the average cost method. Therefore, if adoption of the method is properly timed, no substantial write-down of inventory should be necessary due to price decline in the future, and no taxable income should arise from upward trends of prices of materials included in inventory. If adoption of the method is not timed correctly and a subsequent price decline should occur, the objective of the method may be defeated on two scores, in that it

may be necessary to reflect inventory write-downs in the financial statements and at the same time such losses will not be recognized for tax purposes.

Types of Industries in Which Last-In, First-Out Method Is Most Advantageous

Theoretically, it is possible to use the last-in, first-out method in any case in which either the first-in, first-out or the average cost method could be used. However, the practicability of its application, the pertinency to the purposes for which it was devised, and the practical effect of the results of its use as compared to other methods of cost determination, may vary greatly between various industries as well as various classes of inventory in the same industry.

The conditions which would make the use of the method most beneficial are:

(1) When there is continued need for substantial quantities of inventories, of a type subject to wide price fluctuations, because of inherent characteristics of the business such as slow manufacturing processes, treating processes, etc.

(2) When the relative value of the raw material content of the finished product is large and when, consequently, changes in the cost of the raw materials have a substantially greater weight on the cost of the finished product than have fluctuations in labor or overhead costs.

(3) When finished product is of such a character that selling prices react quickly to fluctuations in the replacement cost of raw materials.

(4) When "hedging" operations are not practicable, either because adequate future markets are not available or for other reasons, and the manufacturer is thereby deprived of a facility for limiting the speculative character of his investment in raw materials.

(5) When the investment in inventories is large in relation to other assets.

(6) When operating processes are continuous.

The method is most useful in those industries in which substantial quantities of inventories must be maintained and where there is an approximately direct relationship between sales and the current costs applicable thereagainst. Generally its usefulness would be more limited in any industry which does not in some way process material. Also, if the method is to be most applicable, the material should be basic and homogeneous and not involve style or design; consequently, it would probably make less appeal to retailers or specialized manufacturing businesses. If a business is merely a dealer in, for example, metals, or if its processing can be completed in a few hours, or if all sales are made for immediate delivery, the first-in, first-out or average cost methods would presumably not produce markedly different results from those shown by the use of the last-in, first-out method.

Requirements of 1939 Revenue Act Respecting Last-In, First-Out Method

Before discussing the use of the last-in, first-out method for the several parts of the inventory, it is desirable to discuss the provisions of the Revenue Act of 1939 within the framework of which specific procedures should be effected.

An application to use the method must be filed at such time and in such manner as the Commissioner of Internal Revenue may prescribe and must specify the goods to which the method is to apply. For example, a taxpayer may apparently specify that the method will be applied only to raw materials not yet processed, or to all raw materials including raw materials in work in process and fin-

ished goods, or to a certain basic raw material, or possibly to the entire inventory.

The regulations with respect to the time and manner of making election are as follows:

" Art. 22 (d)-3, Section 9.22 (d)-3, Title 26, Code of Federal Regulations, 1939 Sup. *Time and Manner of Making Election.*—The elective inventory method may be adopted and used only if the taxpayer files with his return for the taxable year as of the close of which the method is first to be used (or, if such return is filed prior to the ninetieth day after the approval of these regulations, then at any time prior to the expiration of such ninetieth day), in triplicate on Form 970 (revised), and pursuant to the instructions printed thereon and to the requirements of these regulations, a statement of his election to use such inventory method. Such statement shall be accompanied by an analysis of all inventories of the taxpayer as of the beginning and as of the end of the taxable year for which the elective method is proposed first to be used, and also as of the beginning of the preceding taxable year. In the case of a manufacturer, this analysis shall show in detail the manner in which costs are computed with respect to raw materials, goods in process, and finished goods, segregating the products (whether in process or finished goods) into natural groups on the basis of either (1) similarity in factory processes through which they pass, or (2) similarity of raw materials used, or (3) similarity in style, shape, or use of finished products. Each group of products shall be clearly described.

"The taxpayer shall submit for the consideration of the Commissioner in connection with the taxpayer's adoption or use of the elective inventory method such other detailed information with respect to his business or accounting system as may be at any time requested by the Commissioner.

"As a condition to the taxpayer's use of the elective inventory method, the Commissioner may require that the method be used with respect to goods other than those specified in the taxpayer's statement of election if, in the opinion of the Commissioner, the use of such method with respect to such other goods is essential to a clear reflection of income.

"Whether or not the taxpayer's application for the adoption and use of the elective inventory method should be approved, and whether or not such method, once adopted, may be continued, and the propriety of all computations incidental to the use of such method will be determined by the Commissioner in connection with the examination of the taxpayer's returns."

The taxpayer must establish to the satisfaction of the Commissioner that he has not used any method other than the last-in, first-out method in determining income for credit purposes, or for the purpose of reports to shareholders, partners, or other proprietors, or to beneficiaries, for any period beginning with or during the first taxable year for which the last-in, first-out method is adopted. As already stated, however, the taxpayer may use the lower of last-in, first-out cost or market for the purposes of his financial statements.

The provisions of the law which require that *for tax purposes* inventories be priced at cost under the last-in, first-out method, without any allowance for difference between such cost and market, have already been discussed.

Under this method goods in the closing inventory must be treated as being, first, those included in the opening inventory (in the order of acquisition) to the extent thereof, and, second, those acquired in the

taxable year. The Report of the Senate Committee on Finance states that:

"Goods acquired in the taxable year may be treated as having been acquired in the order of their acquisition and so valued, or their cost may be averaged, or any other proper method of valuation may be used with respect to such goods, depending on whatever is the proper treatment under the circumstances."

In this connection, Article 22(d)-2 of the regulations states in part:

"Goods of the specified type on hand as of the close of the taxable year in excess of what were on hand as of the beginning of the taxable year shall be included in the closing inventory, regardless of identification with special invoices, at costs determined as follows:

"(a) By reference to the actual cost of the goods most recently purchased or produced;

"(b) By reference to the actual cost of the goods purchased or produced during the taxable year in the order of acquisition;

"(c) By application of an average unit cost equal to the aggregate cost of all of the goods purchased or produced throughout the taxable year divided by the total number of units so purchased or produced, the goods reflected in such inventory increase being considered for the purposes of Section 22(d) as having been acquired all at the same time; or

"(d) Pursuant to any other proper method which, in the opinion of the Commissioner, clearly reflects income."

Goods of like kind which were included in the opening inventory of the taxable year in which the last-in, first-out method is first used, are to be treated as having been acquired at the same time and priced by the average cost method.

If a taxpayer adopts the last-in, first-out method for, say, the calendar year 1939, the inventory of goods (specified in the application) at December 31, 1938, must be priced at cost in determining the taxable income for the year 1938.

If the method be once adopted, it must be adhered to in subsequent years unless the Commissioner authorizes a change. Should the taxpayer change to another method for credit or report purposes, the Commissioner may require a change of method for tax purposes or may require that the last-in, first-out method be continued for tax purposes.

Application of Last-In, First-Out Method to Various Classes of Inventory

Raw Materials: Probably the simplest application of the method would be in the pricing of one or a limited number of basic raw materials upon which no processing has been done. It would merely be necessary to value the inventory at the same prices which were used in the opening inventory to the extent thereof, and to value any quantities in excess of those on hand at the beginning of the accounting period at prices applicable to acquisitions during the period. Should the closing inventory be no greater than the opening inventory, the same prices would be used for the entire closing inventory as for the opening inventory.

Even in these relatively simple circumstances some peculiar effects may be produced, both in the financial statements and tax returns, if a long interval elapses between sales and replacement of the inventory during a period of rapidly fluctuating prices. It is for this reason that one of the conditions under which the use of the method is most desirable is the need for a substantial stock of the raw material. In some instances

it may be desirable to use a period of time shorter than the fiscal year as the period during which material last in is deemed to be first out.

Problems of more or less complexity may occur in connection with interim statements. Even though sales, production and purchases may have fairly constant relationships over a full year, these relationships may vary substantially throughout the year in a seasonal business and result in inventory valuations founded upon varying and inconsistent price bases at the several statement dates. Again, the solution may lie in a shortening of the fiscal period for inventory purposes, although to do so may defeat the primary purpose of the last-in, first-out method, namely the minimizing of the effect of price fluctuations on the earnings of successive periods.

If the method is applied to all raw materials, no problems should result which differ in principle from those already discussed. However, in some cases it may be found more convenient to apply the last-in, first-out method only to the principal materials which have a significant effect on the financial position and determination of net income.

Work in Process: In considering the application of the method to work in process, two fundamentally different conditions should be recognized. The first is found in an industry where the raw material in respect of which it is desired to apply the method can be identified readily and measured while in process. An example of this class of material in process might be copper sheets used, perhaps, in the manufacture of tanks. The second condition is found in industries where the raw material, as a result of physical or chemical change during processing or due to its presence as part of an assembly, cannot be inventoried as such but can only be identified by detailed analysis of manufacturing specifications. Examples of this condition might be the quantity of tungsten in alloy steel bars or the quantity of copper in an electric motor in course of assembly.

Under the former conditions, the quantity of raw material in process may be combined with similar raw material not yet included in goods in process, and the combined quantities considered in the application of last-in, first-out method. In respect of miscellaneous materials in process, as well as the labor and overhead components, there seems to be no necessity for changing methods of cost determination which heretofore have been found satisfactory.

Under the latter conditions it would seem that existing methods for determining the accumulated costs in respect of goods in process might be continued, with the exception that requisitions evidencing the transfer of materials (for which the last-in, first-out method is used) from raw materials account to work in process, should be priced on a last-in, first-out basis. Apparently it is permissible to use average cost for the current year's acquisitions.

This procedure would have the effect of pricing work in process at the level of most recent costs rather than at a level relative to the cost of earlier raw material acquisitions. However, when the mechanics of internal accounting require the maintenance of a current work in process account separate from the raw material and finished goods accounts, it seems inevitable that the intermediate work in process account will at a given moment reflect the most recent costs. If this were not so, the most recent costs would at no time be removed from the raw material account to be subsequently reflected as the most recent costs of finished product. It should be noted again

that under the Revenue Act the taxpayer must specify the goods to which the method is to apply and may apparently specify that it shall not apply to classes of inventory in respect of which its use is not practicable.

Finished Goods: Many of the features which have been discussed in connection with work in process are equally applicable to finished goods. If the raw material component is identifiable in the finished product, it may be combined with related quantities in the raw material and work in process accounts. When the raw material in question is not so identifiable, the basis for pricing finished product should be the cost records—last-in, first-out. The cost records would also constitute the basis for pricing labor and overhead in finished goods in those instances in which the raw material component is computed separately.

Standard Costs

Standard costs as such are not recognized as a basis for inventory valuation from either a tax or a business accounting viewpoint. In those instances in which inventories are valued at standard costs, it is presumed that appropriate and adequate examination has disclosed that the standards are in substantial agreement with the actual costs, after elimination therefrom of certain elements such as the cost of maintaining idle facilities and excessive costs due to inefficient operation.

In other cases, detailed cost records may be maintained at standards, but the aggregate inventories accumulated from such standards are adjusted by factors which have the effect of stating the total inventories at actual costs without disturbing the detail standards. The usual procedure consists of computing the relationship between total actual production costs and standard production costs. The resultant factor, which is applied to standard costs in order to determine actual costs, is computed separately for the several cost components and departments as may be appropriate in the circumstances.

It seems that such procedures may be continued in connection with the last-in, first-out method. Their effect is to develop the cost of the current year's production. The use of such current costs for valuing inventories will, however, be confined to those quantities which are on hand at the end of the fiscal period in excess of the opening inventories.

Conclusion

Although the last-in, first-out inventory method is adaptable to many circumstances in which other cost methods could be used, it should not be assumed that the method is a panacea for all of the problems which confront business management in connection with inventories. The first-in, first-out method will continue to be an acceptable method of inventory accounting for determining taxable income in any industry. At least until there is a more general adoption of the last-in, first-out method for general accounting purposes, the first-in, first-out method will presumably continue to be an acceptable method for use in the preparation of financial statements. The possible problems involved in the mechanics of applying the new method should also be considered before deciding upon a change.

On the other hand, where the conditions exist which make the new method both logical and practicable, important benefits may be realized from the use of the last-in, first-out method in minimizing the effect of radical fluctuations in the price level upon the income account.

Inventory Valuation from An Appraisal Viewpoint

By CLARENCE CROCHERON

IN a talk that I gave before the New Jersey Society of Certified Public Accountants last March, I said—

> "Recent conversations with public accountants reveal that very few check quantities *and* prices, others check prices but *not* quantities, and still others accept the statements of the management with respect to inventories and qualify their certificates, according to the extent or limitation of their participation."

Since that time, much progress has been made in improving this situation. I understand that many of your members burned the midnight oil in committee meetings wrestling with the inventory problem—and evidence of an important contribution to uniform procedure in taking inventories, is covered in Extensions of Auditing Procedure promulgated by your Society. The opening paragraph under the caption "Inventories" states in part—

> "Added steps may well be taken to give greater assurance with regard to inventories. The extent of such additional procedures will necessarily vary with the circumstances, because the independent auditor is justified in giving consideration to the effectiveness of the internal check and control as applied not only to book records, but also to the procedure of taking physical inventories. But, however extensive these may be, the training and experience of an independent certified public accountant do not qualify him as a general appraiser, valuer, or expert in materials."

Under these circumstances I can speak freely.

What are inventories, anyway—and how much money do they represent?

Stock Inventories consist of every conceivable physical item: mined, harvested, manufactured, processed, or otherwise produced for sale or exchange in the operation of commercial business.

According to the last available report of the Bureau of Census, inventories of manufacturers at the beginning of 1937 were valued at

	$ 8,470,935,859
and at the end of the same year	10,014,330,938
made up as follows:	
Materials and work in process	5,620,775,048
Finish Products ..	4,393,555,890

The allocation of the year end inventory values, according to principal Industry Groups is as follows:

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Industry Group	Materials Supplies, Etc.	Finished Products	Total
Total	$5,620,775,048	$4,393,555,890	*$10,014,330,938
1. Food and kindred products	534,038,566	825,568,879	1,359,607,445
2. Textiles and their products	662,401,604	468,947,423	1,131,349,027
3. Forest Products	235,248,780	285,436,461	520,685,241
4. Paper and allied products	201,905,516	99,532,138	301,437,654
5. *Printing, publishing and allied industries	295,752	120,672	416,424
6. Chemicals and allied products	472,606,578	369,832,977	842,439,555
7. Products of petroleum and coal	197,736,967	273,316,123	471,053,090
8. Rubber Products	97,433,206	123,725,802	221,159,008
9. Leather and its manufactures	162,897,261	126,920,336	289,817,597
10. Stone, clay and glass products	120,264,423	156,243,784	276,508,207
11. Iron and steel and their products, not including machinery	1,014,121,515	565,181,893	1,579,303,408
12. Nonferrous metals and their products	261,030,042	170,116,631	431,146,673
13. Machinery, not including transportation equipment	868,321,003	649,964,591	1,518,285,594
14. Transportation equipment, air, land and water	483,827,319	147,900,104	631,727,423
15. Railroad repair shops	......	......	......
16. Miscellaneous industries	308,646,516	130,748,076	439,394,592

* Subject to certain qualifications on Bureau of Census schedule.

A review of the foregoing schedule reveals that a substantial part of the stock inventories in these industry groups ultimately become fixed assets in the form of buildings, plant machinery and equipment and transportation equipment. The appraiser in his every day work, obtains his primary evidence from the properties themselves and accordingly by training and experience, he *is* qualified as a general appraiser, valuer, and (with certain limitations) as an expert in materials.

I was advised by our Chairman that I would not be required to discuss the quantitative angle of inventories, but rather could confine my talk to methods of valuing inventory items in regard to (1) market prices, (2) quality determination, and (3) physical condition.

Unfortunately, I cannot ignore the physical verification of the inventory because it is right here that most errors and omissions occur. The persons who have the direct contact with the physical inventories are usually dubbed "counters and checkers" and this is all too often an indication of their limited qualifications.

It is not possible to get properly acquainted with your friends by telephone. Neither is it possible to judge inventories except by intimate, personal contact.

A unit of cost is worthy of accurate determination but equally important is the multiplier—in this instance, the quantity. On an engagement involving fixed assets *or* merchandise, the appraiser gets his basic impression and records his primary evidence as to quality, condition and utility during his intimate contact with the physical items, concurrent with the process of validating the quantities. However, it is only due to his long years of specialized experience in the appraisal of fixed assets and inventories of varied types, that the appraiser is qualified to identify and classify the materials

encountered. It is his routine day to day job. Even so, he finds it necessary on many engagements to supplement his personal knowledge with research and collaboration, in order to properly analyze and report upon the items under consideration. Much of the appraisers data is readily available in his manuals and files and this information is being continually brought up to date. His technical library of today is the result of research yesterday.

The first consideration in taking a physical inventory should be the determination of the date as of which the inventory is to be taken, so that there will be no question of the inclusion of items received before, or the exclusion of items received after the selected date.

The inventory is presumed to comprise the listing and verification of quantities and prices of all materials intended for manufacture or sale, and of all supplies used in the operations of the business, exclusive of any items which constitute fixed assets.

There are many forms in use for recording inventory data, but from experience I have found "stock cards", prepared in duplicate, to be most satisfactory for checking purposes.

Time will not permit an outline of the procedure in making the physical check through the use of cards, but suffice it to say that a card should be attached to every piece or lot of material, and on each should be recorded in the space provided—

A serial number (so that all cards will be ultimately accounted for.)

An identifying description of the material.

The quantity (and unit of quantity—lbs. ft.—gross, etc.)

The unit price (for labor—for material).

Overhead (which may be expressed in % of direct labor).

Classification (raw material, work in process—and stage of completion—finished stock and supplies).

Location (building, floor, department).

Condition and obsolescence.

It is during the physical inspection of the inventory that the appraiser makes his observations with respect to the quality and condition of the materials, and gathers any visible evidence of obsolete or slow moving stock.

The various methods of pricing or costing inventories is within the scope of the talks by other speakers on the program. Hence for the purpose of *this* discussion my consideration of *pricing* is limited to its relationship to *value*.

Generally speaking, I believe the following broad principles should be considered in valuing the inventory:

1. Raw materials and supplies should be priced at their cost and market price. Inbound freight, cartage, and handling costs, if paid by the vendee, are part of the raw material cost, and a well defined policy should be adopted on such costs to avoid duplication or omission. Care should be exercised to deduct all trade discounts which the particular management enjoys, and the prices used should be the net price with all trade discounts figured. From the appraisers' viewpoint, cash discounts received for prompt payment of invoices are not generally considered in the determination of the net price. In any event, a consistent policy should be adopted in this regard.

2. Goods in process should be priced to include the cost of materials used in producing them, and the cost of all labor used in bringing

them to their present state of completion, plus overhead expense. Separate unit costs should be determined for (a) materials, and (b) labor; and the *overhead*, which is usually expressed as a percentage of the direct labor cost. In order to price inventory items according to their various degrees of completion, it is necessary to ascertain the labor cost for each operation or step in production, and the overhead applicable thereto. It is not unusual to find in a well-managed company with an adequate cost system that the accurate labor cost for each operation is a matter of record in the Cost Department, and can be used with reliance for purposes of pricing the inventory.

3. Finished stock is priced on the same basis, including material costs, labor costs, and overhead. The labor cost should, of course, include the cost of assembly, finishing in all the final steps, and preparing the item for sale.

Finished Stock is *not* to be included at the selling price (except under special circumstances as in the sugar and meat packing industries).

4. A consistent policy should be adopted with respect to the inclusion or exclusion of the cost of containers, ing cost or as sales expense. If the latter is the case, such items of cost should not be included in the inventory. Containers which are to be returned to the vendor, should be priced at the amount which will be received for their return.

Market prices should be ascertained by a review of current invoices, price lists and quotations and where lower than cost, substituted packing cases, crates, and labor in packing. The treatment hinges on whether these costs are to be included as a part of the manufacturtherefor. Damaged, slow moving and obsolete stock and scrap, should be carefully investigated and appraised with consideration to their salability, and the inventory prices adjusted accordingly.

In closing, I want to say that there seems to be no reason why the cooperative action of accountants and appraisers cannot make a substantial contribution to the validation of this important asset item.

I realize that I have only scratched the surface, but if I have succeeded in putting over the point that "inventories must be seen to be appreciated" then my time and yours has been utilized profitably.

Auditing Inventory Pricing

By MARSHALL GRANGER, C. P. A.

THE auditor's inventory work is three-fold:

1. Confirmation of quantities and ownership including description of the goods as to quality and condition.

2. Investigation of basis of pricing.

3. Tests of arithmetical accuracy, that is, extensions, footings, and recapitulations.

As a result of a recently publicized case much has been said during the past year about confirmation of quantities. On December 5th the Society voted to adopt the report of the committee on auditing procedure covering "Extensions of Auditing Procedure". This report dealt at length with inventory quantities but did not refer to basis of pricing.

The importance of the latter needs emphasizing. It is and always has been one of the most important parts of the auditor's work. It is the section of his work through which in most cases he exerts the greatest influence upon the income accounts and balance sheets of his clients. No matter how accurately he verifies quantities and calculations, he will be subject to severe criticism unless he ascertains that proper prices are used.

Leaving aside all questions of write-downs necessitated by impaired salability, all matters of balance sheet wording, and all problems peculiar to certain trades or industries, the work of the auditor in regard to inventory pricing involves finding the answers to the five following questions:

1. Exactly what is the basis of pricing in use? And, if the company has a cost system, how does it operate? After disposing briefly of the other four questions, I shall return to this one.

2. Is the basis of pricing used by the company in general use in the trade or industry? For department stores the retail inventory method is acceptable; for oil, paper, or metal companies the last-in first-out is.

3. Does this basis correctly reflect the income of the company in every year? If the method involves write-downs from cost to market, are these clearly shown? When prices are moving rapidly up or down, are profits fairly stated?

4. Has the company used this basis consistently in previous years? Comparison with prices used in the inventory at the beginning of the year should be made. The Securities and Exchange Commission requires the disclosure of any change in basis and the approximate effect thereof in dollars.

5. Has this basis been applied to every item in the inventory? Actual tests should be made by the auditor to an extent necessary to satisfy himself on this score. If stock records showing costs are maintained, these should be compared with inventory prices, as should purchase invoices, cost sheets, or other available data.

To come back to the question as to what basis of pricing is in use, theoretically we find three general bases, namely:

1. Cost. While this basis may be used for federal income tax purposes, if used every year, few public accountants would be willing to certify

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to a balance sheet at cost, if market prices were lower, and such market prices could be ascertained.

2. Market, without regard to cost, is used as a basis only in certain industries or companies where long usage and full disclosure make this permissable. By-products and scrap are customarily priced at market as they have no readily-ascertainable cost. The term "market" means two distinct things (1) current purchase price or reproductive cost, and (2) current selling price less delivery and selling expenses. Market means the lower of these two things applied separately to each item in the inventory, not merely to the inventory as a whole. Expected losses on big contracts as well as on small articles or damaged goods will be provided for, if inventory prices do not exceed estimated selling prices less delivery and selling expenses.

3. Cost or market, whichever is lower. While this is the basis of inventory pricing in general use, it does not follow that uniform bases are employed by various companies, even in the same trade or industry. The wide divergence between companies is the result of the almost unlimited number of meanings of the term "costs".

Kinds of Costs

The five general classes of costs most widely used, each with innummerable variations, are as follows:

1. Specific cost of identifiable units. This method may be used where intermingling of like items does not make it impossible. Even in such cases other methods are often preferred.
2. Standard cost. Cost of goods sold and goods in inventory may be computed at standard costs. Inventory prices may be based upon the standard costs for the year or part of a year just ended or upon new standard costs calculated for the coming year. If standard costs are used for pricing the inventory, the auditor should investigate them carefully, as discussed later.
3. Average cost. This may mean any one of a number of things. Probably the most widely used average cost is the running or moving average. Perpetual inventory records are usually kept. Under this method quantities sold or used in production are priced at the average cost of the units on hand. New quantities are added at intervals at their new cost and a new average cost is calculated on a weighted basis.
4. First-in, first-out cost. This is the old familiar method based on the theory that the oldest units are sold or used before more recent acquisitions are disturbed.
5. Last-in, first-out cost. This is based on exactly the opposite theory from the first-in, first-out method. Under this method the most recently acquired units are assumed to be used before those underneath.

Other well-known methods are not included here as they have more limited or specialized uses. Examples are the retail inventory method and the base-stock method. The Treasury Department allows retailers to use the former method, but specifically prohibits the use of the latter.

All of these five cost bases are not applicable to every industry or company. Any one of them may be used for federal income tax purposes provided it (1) conforms to the best accounting practice in the trade or business and (2) most clearly reflects the income.

An interesting subject for an article, or perhaps a book, is the varia-

tions in these five cost methods actually in use at the present time. You should not feel that, as soon as you have classified the pricing basis used by a company under one of these five groups, you really know what the basis of pricing is. Among the further questions you should ask yourself, the two first ones are:

1. What length of time is used as the unit in computing costs? This question applies to overhead costs under any method and to material costs where average, first-in, first-out, or last-in first-out costs are used. With any of these three methods the year, quarter, month or day may be the unit of time used in adding new purchases or acquisitions to the quantity on hand at the beginning of the period. The unit of time may make substantial differences in the resulting costs. In some instances, sales or deductions are made on the basis of a time unit different from that used for purchases or additions. This variation also produces different results. Cumulative computations may be made each month using the entire period from the beginning of the year. This has been advocated as the best method for interim periods under the last-in first-out method. Instead of using a specific unit of time new costs may be figured each time transactions occur, as in the case of castings made at infrequent intervals in large lots.

2. Does the company have a cost system? If so, what kind? The auditor must review the cost system thoroughly.

Review of the Cost System

To what extent should we review or test the cost accounting system in use? The answer to this, in my opinion, is that we should go far enough to obtain answers to the following ten questions, and these answers should be obtained, not from conversation, but from the records themselves:

1. Are the cost accounts "tied-in" with the general ledger? In other words, does the company operate a cost ledger or group of cost accounts which are in balance with one or more controlling accounts in the general ledger?

2. Is the cost system adequate? That is, are the cost records sufficiently detailed and well-planned to provide the data needed to calculate costs accurately in accordance with the cost method in use? You should obtain and study a trial balance of the cost accounts in order to answer this question.

3. Has the system been operated intelligently and accurately during the year? Audit tests of invoices, payrolls, and other supporting documentary evidence may be necessary to satisfy yourself about this.

4. Are all proper items and no improper items included in overhead expenses? All manufacturing expenses belong in overhead costs, but no selling, delivery, administrative, or financial expenses should be included.

5. Is overhead expense properly allocated between departments and products? What is the basis of allocation? Is it equitable? Is the allocation in current use based on current figures? When was it last revised?

6. Are standard costs used, and, if so, to what extent? Are materials charged into work in process at standard or at specific, average, first-in first-out, or last-in first-out cost? Are standards

used for direct labor? What is the basis used for overhead expenses?

7. If standard costs are not used, do the costs used include unusual items which distort the figures and should be excluded? Examples of such unusual items are strike losses, fire damage, and idle equipment expenses. Do costs vary greatly between months? If so, why?

8. If standard costs are in use, how much was expended on each item of cost, how much was the variance, and what was the percentage of each variance to the total related expenditure? In obtaining these figures you must know what cost basis is in use before deciding whether to prepare them for the year as a whole, for certain months, or for certain specific lots or groups of products.

9. What were the causes of these variances, and does their nature necessitate a blanket adjustment of inventory cost prices from standard costs? This will be commented upon in connection with the next question.

10. Do the causes of under- or over-absorbed burden justify inventory valuations at normal burden rates? This question is similar to the preceding one. The only difference is that under- or over-absorbed burden, as you know, results from production less or greater than the advance estimate, whereas cost variances result from higher or lower prices than anticipated for materials, labor, or overhead expenses. The recent questionnaire of the National Association of Cost Accountants indicates that very few companies using standard costs take the trouble to adjust inventory prices from standard costs. This, however, does not excuse the auditor, if he fails to obtain complete answers to the above questions. Costs calculated after production, not standard costs, are the correct basis of pricing inventory. Standards are only advance estimates which are a great convenience, but may turn out to be right or wrong. The auditor must find out which. When inventory is priced on the basis of new standard costs prepared for the coming year, these prices are probably widely different from last year's costs. However, they may represent, or be very close to, market, as being the company's best estimate of current reproductive cost. These facts the auditor must investigate. When market quotations are rising, the new standards usually represent unit figures higher than costs. In this case a blanket adjustment on a precentage basis, or other equitable basis, should be made to reduce the inventory to cost computed for the period just ended on a specific, average, first-in first-out, or last-in first-out cost basis.

When No "Tied-In" Cost System Exists

If a manufacturing company has no cost accounting system or has one which is not "tied-in" with the general ledger, how can we satisfy ourselves as to inventory prices of finished goods and work in process?

If it has no cost system, it probably prices its finished goods and work in process on the basis of someone's estimate of the cost of each item. In such a case the auditor must obtain as much information as possible from this individual and from whatever records or estimates exist, as to details of these estimated

costs. The auditor must try to divide the unit cost of every item, especially those comprising the greatest money value in the inventory, into material, direct labor by manufacturing departments, and overhead costs by departments. He must also obtain as reliable figures as possible as to quantities of each item produced during the year or other period used as a unit.

When he has done these things, he has reduced his problem to that of the auditor of a company which has a cost system not "tied-in" with the general books. The problem of the auditor of such a company is not an easy one, but it may be stated in very simple language. His problem is to "tie-in" the cost estimates with the general books of the company. The four steps in this process are as follows:

1. Determine whether to use the last year, quarter, month, or shorter period to figure costs for inventory purposes. The answer to this will depend upon the cost period consistently used by the company in the past, unless the auditor decides that this method does not clearly reflect income and financial condition of the company and so must be changed.
2. Compare, as accurately as he can and in as much detail as the records permit, manufacturing costs for the period, as shown by the general books, with total estimated cost of quantities produced during the period. In this comparison costs should be divided between materials, direct labor, and overhead. If possible, further sub-divisions should be made between kinds or grades of materials and between labor and overhead of various departments or processes.
3. Review the figures obtained to ascertain whether or not cost estimates are reasonably accurate. Make sure all elements of overhead have been provided for in estimated costs and that the basis of distributing overhead between departments or commodities is fair.
4. Adjust inventory prices, if necessary, to equal estimated costs, as corrected to "tie-in" with total costs for the period as shown by the general books.

Discussion of Papers Presented on Inventory Pricing

IN the discussion which followed the presentation of the papers on "Inventory Pricing" the following are some of the questions which were presented:

Question: I think it is wrong to state that any class of expense can be labelled as fixed overhead. There is, in my opinion, practically no class of expense which is *pure* fixed overhead, and no class of cost which is pure variable overhead. Even such items as depreciation and taxes, considered as fixed overhead, will vary from period to period depending on units produced. Similarly, even raw materials and labor per unit will vary depending on units produced. The classifications of fixed and variable are merely for convenience and not required by logic."

Answer: Naturally the classification of expenses as fixed and variable is a classification for convenience. Most of our accounting classifications are made because they are convenient, i. e., they serve a purpose. Accounting is a service function, and any classification which is convenient and useful is therefore logical.

There is a basic and logical difference between fixed and variable expenses. Any rent payer, borrower at interest, taxpayer, or payer of life insurance premiums can attest to the fact that for the period covered by the contract these expenses are fixed. On the other hand where workmen are paid on a piece-work basis, labor cost is directly variable. In between these two extremes are the many cases of semi-variable expenses.

It should be remembered that many of our expenses are fixed because of management decisions, but for accounting purposes they are often as fixed once management reaches a decision as they would be if controlled by natural laws. Costs arising under a great variety of contracts are of this type. Somewhat different is depreciation. Where management decides that assets shall be depreciated on a straight-line basis, such depreciation is a fixed cost; where the unit of production is used as the depreciation basis, the depreciation cost is variable.

What value is there in discussing whether the classification of expenses as fixed and variable is based on logic or convenience so long as such a classification serves a useful purpose and is in accord with the facts?

Question: How would you find the proportion of fixed and variable expense in a semi-variable expense? Give an example.

Answer: To determine the proportion of fixed and variable expense in a semi-variable cost, I would first make a tabulation of actual expenses for several months in the past, selecting months ranging from low to high production. After eliminating from such figures any unusual or nonrecurring items, I would plot these costs on a chart showing production volume on its horizontal axis and dollars of expense on its vertical axis. Then I would draw a straight line to intersect the greatest number of points. If the expense was completely variable, this straight line would intersect the vertical axis at zero, but if the expense was semi-variable, the point of intersection would be above zero and will indicate the amount of the fixed expense.

To illustrate, let us assume that maintenance labor in a department

showed the following relation to units produced:

Units Produced	Cost of Maintenance Labor
250	$37.50
500	50.00
750	62.50

The expense in this case is semi-variable because it increases with the volume of production but not at the same rate. For each increase of 250 units, there is an increase of $12.50 in expense or 5 cents per unit. This is the variable element. When 500 units are produced, the variable cost is $25 (500 x .05), leaving a fixed cost of $25. Likewise when 250 units are produced the variable cost is $12.50 (250 x .05), again leaving a fixed cost of $25. This expense can be described as amounting to $25. plus 5 cents per unit.

Question: In marketing a new product, what treatment should be given to unabsorbed overhead arising directly from unused capacity? Should this item be deferred on the basis of future over-absorption of overhead or be charged against current operations?

Answer: The unabsorbed balance should be charged against current operations, whether the company is marketing a new product or an old-established line. Future volume of production is too difficult to forecast to warrant the assumption that future over-absorption will offset past under-absorption. Future periods receive no value as a result of under-absorption in the past.

Question: You mentioned certain firms that pro-rate overhead costs to inventory.

(1) Would the Revenue Department refuse to approve this, particularly in the case of a new concern that is going to show a substantial loss in its first year of operations?

(2) Would this be acceptable in a statement to credit grantors, or would it be considered an overvaluation?

Answer: Apparently the question refers to the proration of any under-absorbed overhead between inventories (finished goods and goods in process) and the cost of goods sold. The result of such a proration is to restate the inventories on an actual cost basis. It is impossible to say definitely what the Revenue Department will or will not accept, and naturally decision in any particular case might be influenced by the importance of the under-absorbed balance to total costs. If 100 units were produced in a plant with a normal capacity of 2,000 units, the decision might be quite different from what it might be if 1,500 units had been produced in the same plant. I would assume that except in extreme cases of unused plant capacity, the Revenue Department would accept actual costs arrived at by prorating under-absorbed overhead arising from the use of normal rates to inventories and cost of goods sold. However, such a valuation might be considered as being in excess of market, so far as overhead is concerned, particularly where the Company is operating at a higher rate of output at the end of the year.

With reference to the second part of the question, I would be inclined to object to a statement to credit grantors which showed inventories valued at actual cost for a plant operating far below normal capacity. Obviously the inventories are overvalued because there has been included in their costs the fixed expenses for that portion of the normal plant capacity which was not utilized in their production. The failure to utilize this capacity results in a loss which should not be loaded onto inventories.

Question: What is the speaker's opinion of the following statement?:

In almost every case where the base stock method results in a cost of sales representative of current market and production costs, the last-in, first-out method will serve equally as well. But not vice versa.

Answer: I think that statement is correct. In the base stock method an arbitrary base quantity is assumed. With the passage of time the inventory may exceed substantially that arbitrary quantity. As the excess is valued on a first-in, first-out, or an average cost basis, the effects of the latter methods are present with respect to that excess. If the last-in, first-out basis is used, the entire inventory will be valued at the cost of the earliest acquisitions—not merely the quantity equivalent to the assumed base stock.

Question: The speaker stated: Taxpayer must establish that he has not used any other method than the last-in, first-out in determining income for credit purposes, reports to stockholders, etc. Later: A taxpayer may use lower of last-in, first-out cost or market for financial purposes without sacrificing right to use last-in, first-out cost basis for tax purposes. Please reconcile this apparent contradiction.

Answer: The requirement that the taxpayer use no method other than last-in, first-out in determining income for financial purposes in effect is a requirement that the method of determining the cost of the inventory be the same for financial and for tax purposes. In other words, the taxpayer is not permitted to use one method for determining cost for reports to stockholders and a different method for tax returns. If at the close of a particular accounting period, the taxpayer states his inventory for financial purposes at a value less than last-in, first out cost, the resultant write-down is simply an unallowable deduction.

Question: T.D. 4959 provides that if the "last-in, first-out" basis is used reports to shareholders, etc. shall be on that basis. Since the 1939 amendments and the Regulations were enacted and issued after several months of the calendar year 1939 had elapsed and interim reports had been issued on some other basis (such as "first-in, first-out") could any taxpayer having this experience use the "last-in, first-out" basis in 1939?

Answer: The language of the law and Regulations is quite clear. Under a strict interpretation thereof taxpayers who have used inventory methods other than "last-in, first-out" in the preparation of interim reports would not be permitted to use the "last-in, first-out" method in computing taxable income for the year 1939. There have been no indications that the Commissioner will deviate from a strict interpretation of the language.

Question: Assume the following facts:

Inventory January 1, 1,000 units—value $1,000;
Inventory June 30, 100 units—value $100;
Inventory December 31, 1,000 units.

Is the December 31 inventory valued as at January 1 or is the December 31 inventory valued at 100 units at the January 1 price and 900 units at prices paid subsequent to June 30?

Answer: The Regulations provide that goods remaining on hand at the close of the taxable year must be treated first as those included in the opening inventory of the taxable year (in the order of acquisition) to the extent thereof and, second, those acquired in the taxable year. Pursuant to these provisions the inventory at the close of the taxable

year being not in excess of the inventory at the beginning of the taxable year, the entire inventory should be priced at January 1 prices.

Question: What is your opinion of the purpose and effect of Sec. 22(d)-4 of T.D. 4959? Do you think it is superfluous as having been covered elsewhere in the Regulations?

Answer: The provisions of this paragraph are covered elsewhere in the Regulations. The purpose appears to be to place the taxpayer on record at the time he files his application that he agrees to the adjustments which are set forth in the paragraph.

Question: Does the appraiser in verifying quantities actually count, weigh or measure, or does he merely observe the counting, weighing, and measuring as done by others—say, management employees? If the latter, how does this differ from what the accountant would do? If the former, isn't the cost prohibitive? If neither method, but tests are used, how does this assure that inventory not tested is in accordance with tests, or how would a deliberate overstatement of inventory be revealed?

Answer: I purposely avoided any comparison of the respective qualifications of the accountant and the appraiser in taking inventories, but as you brought up the subject I shall hazard a reply.

There are two distinct field operations in taking the physical inventory—(1) counting, weighing and otherwise measuring the quantities and (2) validation or correction of these results.

Most industrial companies have some form of production control, so as to assure an uninterrupted flow of materials through the plant, from their raw to finished state. The employees of such companies are familiar with materials and consequently competent to assist in the *first* operation, i. e. counting and weighing. Here the appraiser does not merely "observe" but he actively participates in instructing stock clerks, directing department heads and coordinating the hundred and one loose ends, thereby assuring the preparation of an orderly and comprehensive record, capable of checking. With regard to the *second* operation, that is validation of the inventory, the appraiser considers this his full responsibility and accordingly counts, weighs and otherwise measures quantities independent of the management or its employees. Circumstances, however, determine whether the appraiser's responsibility will be discharged by test checks made at random or, whether a partial or complete detailed check is required.

In any event it is not enough for either the accountant or the appraiser to merely "observe". The appraiser obtains his primary evidence from the property and accordingly this procedure precludes the likelihood of overstatement. By training and experience the appraiser is qualified to identify and judge the materials which he observes as to quantity, quality and condition.

To take a specific case: the last inventory over which I had supervision, *both* operations, that is the (1) counting and (2) validation, were done by the appraiser. Costing was done by the public accountant and the final valuation determined by the appraiser—the latter giving effect to current price levels where lower than cost, less further allowance for obsolete and damaged goods. Our participation on this inventory was in the capacity of subcontractor for one of your members and whether or not the cost was prohibitive I will leave to you—it amounted to about 25% of the audit fee.

A real contribution to the validation of inventories may be realized by the cooperative action of the ac-

countant and the appraiser; the accountant obtaining his evidence of ownership and cost, from the *records* and the appraiser obtaining his primary evidence as to existence, quantity, quality and condition, from the *property.*

President Stempf: It is my positive conviction so far as the accountant is concerned and my opinion in so far as any other expert is concerned—that he shall not take, determine or supervise any inventory. The formation of original opinions and judgments affects every one of these factors.

This question of variable and fixed expenses is one of management's determination as to which category it should be placed in—a matter of judgment and opinion, based upon the surrounding circumstances—and the responsibility for the original judgment, the determination upon which the accounts are expressed, rests with management, and the duty of the expert—whether he be an appraiser or an accountant—is to satisfy himself as to the credibility of the representations made by management, as to the fairness of those representations, and I don't think that the expert of either class should permit himself to be put in the position of making the original determinations for the client, thereby placing himself in the position of making the primary representations. Those primary representations should be made by management, and his duty is to express an opinion as to the credibility—the fairness—of the representations made by management.

I think that that is basic in the professional relationship, whether we are speaking of the accountant, the appraiser, or any other type of expert.

Question: What is the place of inventory price and cost accounting in proceedings under the Robinson-Patman Act?

Answer: In proceedings before the Federal Trade Commission under the Robinson-Patman Law, the place of inventory price and cost accounting might be called the last line of defense, and for this reason:

The Federal Trade Commission must first establish the credible case against you in respect of an alleged discrimination. At that point the burden of proof in denying this allegation falls upon the respondent. He may then try to attack the evidence presented by the Federal Trade Commission in respect to various requirements of the above mentioned "credible" case. These requirements briefly are as follows:

The sales involved must have been made primarily within Inter-state Commerce, and must have been made in respect to commodities of a like kind or quality, and finally, and most important, the prices must have discriminated between customers, and have tended substantially to lessen competition.

Having failed in disproving the case so made by the Commission, and if unable to prove that the discrimination in price was made to meet competition, the respondent must then turn to his costs and prove thereby that the differences in sales prices were warranted by like differences in cost.

Question: When inventory is moved from a plant to a sales or storage point, what is the usual practice in recording the freight incurred? — (a) Added to inventory cost? (b) Treated as a deferred charge? (c) Charged off as a selling expense?

Answer: In order to know the usual practice it would be necessary to send a questionnaire to a number of companies having such a problem. I do know, however, that each of these three methods is being used.

If the freight is of great amount, sometimes it is added to the inventory when it arrives at the various storage plants, or at the various sales agencies. In such cases the inventory at any given time includes the freight. Some companies go a step further and also add to the inventory the labor of placing the items in the storage location. If it is of small consequence, it should not be added because it complicates the checking of the costs of sales, especially when the costs are checked at the home office, for there would be a different set of costs for each storage plant or agency.

Sometimes it is treated as a deferred charge. In all these cases you must be consistent. Large parts or units are sometimes sent in carload lots from the factory to sales offices, and in such cases occasionally the sale to the customer is made f.o.b. factory, so that the charge to the customer may be greater for each item than that arrived at by dividing the carload lot freight by the number of large parts or units. A profit may be made in this way. In such cases, sometimes the carload freight is deferred, and as the items are sold the profit is recorded. If the shipments are practically the same from year to year, the freight may be charged to expense and freight collected from customers credited thereto.

If charged to selling expense, it is a question whether to charge it to selling expense of branches or warehouses or to the main office. If charged to branch selling expense or costs, it interferes with the comparison of results of various branches. For this reason it may be better to charge it to a main office account.

Question: Is buying expense added to inventory?

Answer: It is a question of what type of buying expense you're talking about.

If it has to do with a purchasing department as such, under normal conditions only a portion of that expense would find its way into inventory through being charged to overhead.

If you're talking about buying expense such as buying expense for crops, sending out buyers, buying wheat, corn, tobacco, it is definitely part of your inventory cost.

Question: For statement purposes, it is desired to have the inventory of a Dutch firm valued at cost in American dollars.

The merchandise (precious stones) was purchased at various times in Europe for pounds sterling, and the cost converted to guilders.

Should the conversion into dollars be made *now* on the basis of the current high-priced guilder or the weakened pound?

Answer: We do not know whether the merchandise is in Holland or the United States. But let us assume it is in Holland and belongs to a Dutch firm owned by, and to be consolidated with, an American company. It is immaterial whether or not the stones were paid for in pounds sterling or guilders because the Dutch firm would have to use guilders to pay for the pounds. So the cost for our purposes would be in guilders. Precious stones as inventory have certain peculiarities; they may be worth much more or much less than cost. The war also enters into the picture and may at present seriously impair their market value. However, if they could readily be transported to the United States, they would still have a market value in American dollars. Under these conditions cost in guilders should be convertd at current rates into dollars and this cost should be

used in pricing inventory unless market value is lower. If the amount involved is substantial, full disclosure should be made on the balance sheet.

Question: A manufacturer of engines in servicing his product replaces a fuel pump at any time for $35 and the return of the pump originally in the engine. The pump cost $300. Used pumps are reconditioned and used interchangeably with new pumps in subsequent replacement and apparently are efficient. Should the reconditioned pumps be valued at an appraised value when returned with reconditioning costs added to determine inventory cost?

Answer: When a pump is returned the cost of reconditioning should be estimated as accurately as possible. Inventory value would ordinarily be calculated by subtracting this estimated reconditioning cost from $300, but should in no case exceed $265. As labor and materials are expended in reconditioning they should be added to inventory value up to a limit of $300.

Investment Trusts

THE papers which follow were presented at a round-table forum meeting on the evening of April 12, 1939, at the Hotel Woodstock under the direction of the Technical Committee on Investment Trusts. The meeting was opened by Mr. A. S. Fedde, Vice President of the Society who discussed generally some of the accounting problems relating to Investment Trusts and then introduced Mr. Christopher H. Knoll, Chairman of the Committee, who presided.

Certain Practices in Investment Trust Accounting

By GEORGE E. NIVEN, C.P.A.

A review of the definition and theoretical objectives of an investment trust will undoubtedly supply a clue to the development of some of the accounting practices applicable to investment trusts.

Definition and Objectives

"An investment trust is a corporation or a voluntary association engaged primarily in the business of investing and reinvesting in the securities of other companies for the purpose of revenue and profit and not, in general, for the purpose of exercising control; to provide investment diversification, to realize on appreciation when conditions are favorable, to protect in so far as it is possible by means of diversification of risks and astuteness of management the assets from diminution when economic conditions are unfavorable and, finally, to assure continuous income consistent with sound principles of investment."

The type of the trust, the scope of its operations, the make-up of its portfolio, and the experience and integrity of its management are among some of the factors which would tend to either modify or expand these objectives. However, the outline given is probably sufficiently comprehensive to serve our purpose. The fact that all investment trusts do not accomplish these lofty aims is not germane to this discussion. Accountants are interested chiefly with acting as impartial reporters of facts as they are found to exist.

Types

Investment trusts may be broadly classified under four general types:

1. Fixed.
2. Semi-fixed.
3. General management.
4. Investment contracts.

A fixed trust purchases a definite number of shares of stocks or bonds of usually a specified number of companies. In this type of trust, there are usually no sales of portfolio securities except for eliminations, and, consequently, there is no reinvestment problem. A semi-fixed trust follows the general principle of a fixed trust, except that reinvestments may be made in certain eligible securities usually mentioned in the fund agreement. The general management fund is distinguished from all others by an active management on the part of the Trustees or managers of the trust. The shares of such companies or associations are sold to the general public and the proceeds invested in a diversified list of securities. The "open-end" trust is characterized by the fact that the trust repurchases and resells its own shares more or less continuously. Investment contract

trusts are of a more recent innovation which were developed to enable individuals to purchase units in a fixed trust on an installment basis usually over a period of ten years. Very recently this type of trust was expanded to permit the purchase of shares in general management trusts. Irrespective of the type of trust involved, the same general accounting principles prevail, except that the question of security profits and their treatment is much more acute in the general management type than in any of the others named.

Capital Stock

In a business corporation, the capital stock account remains static as a general rule, except for new issues and occasional retirements, whereas, in an investment trust, the capital stock account, particularly if it is an open-end trust, constantly fluctuates according to the number of shares sold and the number of shares reacquired. The method of recording the changes is no different than in any other corporation.

Paid-In Surplus

The paid-in surplus account likewise fluctuates in amount as new shares are issued and old ones reacquired, but not always in the same proportion as the capital stock account. This is because the price at which the shares are sold is governed by the market quotations of the securities in the portfolio of the trust. To this account is credited the excess of the consideration received from the sale of capital stock over the par or stated value, and conversely is debited with the excess of the consideration paid for stock reacquired over the par or stated value of the stock. However, the foregoing must be qualified in this respect. When shares are issued or reacquired, there is included in the price at which the shares are sold or repurchased (liquidating value), the accrued undivided earnings applicable to those shares. Therefore, depending upon whether the shares are being repurchased or sold, the paid-in surplus account is debited or credited with the proportional amount representing accrued undivided earnings. It has been the practice to equalize only accrued undivided earnings from sources other than security profits and losses in respect of sales and repurchases of capital stock. This has been the practice mainly because security profits have been looked upon as special or extraordinary profits and not subject to current distribution, and, further, that security losses present a somewhat perplexing problem in equalization.

Principal Account

As previously mentioned, an investment trust may be either a corporation or a voluntary association. Inasmuch as an association is not a corporate entity, it does not issue shares of capital stock but in some cases shares of beneficial interest having a par or stated value are issued. The selling price (liquidating value) of these shares is computed in exactly the same manner as those of an incorporated trust. The following will illustrate how the net asset value (liquidating value) of shares is derived:

Total securities at market.....	$1,000,000.00
Principal cash and accounts receivable — less accounts payable	150,000.00
Income cash and receivables, less accrued expenses.......	20,000.00
Total net assets at market	$1,170,000.00
Number of shares outstanding..	78,000
Net asset value per share.....	$15.00

The capital stock account, and the surplus accounts, in so far as they relate to capital transactions, of an incorporated investment trust are

replaced in an unincorporated trust by what is commonly called the principal account. While it is quite true that in some trusts the balance of the principal account represents the net asset value of the trust, it is preferable that from it be excluded all items of investment income and expense. Consequently, the main credits to that account would consist of:

(a) Amount received from shares sold excluding amount of accrued undivided earnings included in price of shares.

(b) Realized net gains from sales of portfolio securities, less realized losses, if any.

The debits to this account include:

(a) Cost of shares repurchased, exclusive of accrued undivided earnings included in price of shares repurchased.

(b) Distributions to stockholders only from capital gains.

(c) Capital expenditures incidental to distribution of shares (e.g. Federal Securities Act registration fees).

(d) Stamp taxes on original issue.

For convenience and ease, subsidiary accounts are usually maintained for each of the items mentioned, the principal account being the control.

Income Account

The income account is usually restricted to investment income and expenses of administering the trust. Realized gains or losses from sale of portfolio securities are segregated in a separate account. The expenses are usually comprised in part of the following:

Supervisory fees
Custodian charges
Transfer agents charges
Legal and accounting fees
Provision for taxes
Rent
Sundry

Realized Profits or Losses on Sale of Portfolio Securities

Increasing recognition that gains or losses are not in the nature of recurring income has led to the segregation of these items from investment net income. While the practice is not universal, the net result of such transactions is usually transferred to a special earned surplus account. Prior to the advent of the undistributed profits tax and the creation of what has come to be known as "Mutual Investment Companies" under the Revenue Acts of 1936 and 1938, if net gain was realized it was not necessarily distributed to the shareholders but the gain was transferred to a special surplus or a reserve account. Now, however, the tendency is to make special distributions to shareholders for the approximate amount of such net gains, less the normal tax applicable to said gains in the case of companies not qualified as mutual investment companies in order to escape the punitive tax imposed on the non-distribution of such profits. Some trusts have adopted the federal tax basis of computing cost of security sold for their general accounting; such procedure being followed to avoid the keeping of two sets of security records.

Three methods in common use for the purpose of determining profits or losses from sales of portfolio securities are:

1. Identified cost,
2. First-in — first-out, and
3. Average cost.

There is probably no phase of accounting practice relating to investment trusts which can provoke more discussion with the resultant lack of unanimity of thought than the question of what basis should be used in computing profits or losses on sales of securities. It is strange, but nevertheless true, that the two methods

which are countenanced by the government in determining profits or losses for tax purposes should be frowned upon by the more conservative opinion. The Securities and Exchange Commission in administering the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, disapprove of the first method—namely, identified cost method, are tolerant of the second, and prefer the third. It is the consensus of opinion of your committee that the average cost method is the preferable method. The New York Stock Exchange in its requirements for listing investment trust securities, says that, "average cost appears to be the only one which does not result in a distortion of the income account." The Stock Exchange also requires that the method of computing cost of securities sold must be described in all financial statements presented and attention called to any changes whatsoever in accounting methods within the period covered by any financial statements.

Any gain or loss realized by an investment trust from trading in its own shares should not be carried into earned surplus, but should be reflected in either the capital or paid-in surplus account.

Financial Statements

The published financial statements of an investment trust usually consist of:

1. Balance sheet
2. Statement of principal if a voluntary association
3. Statement of paid-in surplus
4. Statement of earned surplus
5. Statement of income and expenses exclusive of realized gain from investments
6. Statement of net profit or loss from sales of securities
7. Statement of portfolio securities showing:
   - (a) Number of shares owned
   - (b) Cost
   - (c) Market values or estimated fair value in the absence of market quotations

Any paper on this subject would not be complete without reference to the influence exerted by accountants, the New York Stock Exchange, Blue Sky Commissions, and, finally, the Securities and Exchange Commission, each in their own sphere, upon the method of public reporting. This influence has resulted in raising the general level of financial statements. Specifically, they relate to the balance sheet, asset valuations, and the income statement. In order to readily appreciate the extent and degree of improvements in financial statements which have occurred during the last ten years, one need only compare the meager and non-informative data which was found in financial statements published during the nineteen-twenties with the voluminous information now being presented. It was quite common to see on a balance sheet the portfolio securities extended net of investment reserves with cost, market value and amount of reserves being omitted. A footnote might explain that the market value of the securities were in excess of book values without giving the aggregate market value.

The income statement would probably group in a lump sum the amount of interest, dividends, stock dividends and realized investment profits.

Today the cost and market values must be shown in the aggregate and for each security, and investment profits must be separated from investment income.

Accountants are not in entire agreement on the question of cost

vs. market values in stating the portfolio securities on the balance sheet. Some lean to extending the securities at cost with market values shown parenthetically, while others prefer extending the securities at market quotations with cost as a parenthetic notation. The writer is of the opinion that valuing the securities at market quotations with cost shown parenthetically is to be preferred over the other method of presentation. It seems to the writer that cost is of historical significance but that the investor, or potential investor, is more concerned with the value of the assets of a trust, such value commonly being measured by current market quotations.

Where investments are carried in the balance sheet at amounts based on market quotations, it is preferable to show the net unrealized depreciation or appreciation of investments as a segregation of surplus. This method of segregation seems preferable to avoid the combining of realized elements with the unrealized.

Again referring to the presentation of security values on the balance sheet of an investment trust. The Securities and Exchange Commission now requires that there be added to the balance sheet a footnote indicating what the effect would be upon the surplus accounts had a reserve for unrealized depreciation been established, provided that the aggregate amount at which the securities are carried exceeds the market value based on current market quotations and that a sufficient reserve to cover such excess had not been set up.

Also appended as a note to the balance sheet, will usually be found a statement reading like this:

> "Net assets based on market quotations for portfolio securities were equal to $ per share of capital stock issued and outstanding on December 31, 1939."

or

> "Value of capital stock per share was $ on December 31, 1938, computed on basis of balance sheet with marketable securities extended at market quotations on same date."

As is now the usual custom, all changes of accounting methods within the period covered by the statement or since the last accounting period must be noted in the auditor's report accompanying the statements, or as a footnote to the statements themselves and referred to in the auditor's report. The following is a typical example of such a footnote:

> "Prior to December 31, 1935, net losses from sales of securities aggregating $600,000.00 were charged to paid-in surplus, and net profits from sales of securities for year ended December 31, 1936, amounting to $500,000.00 were credited to paid-in surplus during that year. It was the policy of the company to credit net profits from sales of securities to paid-in surplus to the extent of the loss previously sustained and charged against paid-in surplus. In view of the fact that the company desired to qualify under Section 48-E, of the Revenue Act of 1936, all net realized profits since December 31, 1936 were not credited to paid-in surplus, but were distributed as indicated on the accompanying statement of profits and losses on securities."

It is also required, not only by accountants in general but also by the New York Stock Exchange in its requirements for listing Investment Trust Shares, that the statement of income carry a footnote stating the

increase or decrease during the year of the amount by which the market value of securities owned exceeds or is less than book value. If the statement of income is for a period longer than one year, the footnote must show the increase or decrease of market value to cost for each year or period.

Taxation

Investment trusts, whether incorporated or unincorporated, are, with certain exceptions, subject to the same rate of taxation under the federal income tax laws as any other business corporation. The exceptions are in the case of trusts which can qualify as, "mutual investment companies" under Section 361 of the Revenue Act of 1938. Under this section an investment trust which qualifies is taxable only upon its undistributed net income at 16½%, one of the qualifications being that it shall distribute at least 90% of the taxable net income. If an unincorporated trust is a strict trust within the meaning of Section 166 of the Revenue Act of 1938, it escapes all taxes assessed against corporations. However, the line of demarcation which distinguishes between an association taxable as a corporation and a strict trust with the income taxable to the grantors is so thin that accountants are advised to request their clients to obtain a ruling from the Bureau of Internal Revenue as to whether the trust is or is not taxable as an association, if the client contends that the net income of the trust is not taxable to the trust. If the client declines to apply for a specific ruling, the accountant should, in footnotes to the balance sheet and income statement, explain the facts in clear and concise language. He should state the amount of contingent liability for federal tax that would be payable in the event that the Bureau held that the trust was an association taxable as a corporation.

Investment trusts doing business in New York State are taxable under Section 214-b of Article 9-A of the tax law. This section provides for a tax of 4½% on the entire net income within the state, subject to the limitation that the entire net income from within the state shall not be less than 15% of the entire net income of the trust. The 15% limitation can be overcome if the trust can prove to the satisfaction of the tax commission that less than 15% of its business is carried on within the state. An alternate tax is provided computed upon the net asset value of the issued capital stock within the state, subject to the same 15% limitation previously mentioned. The method which derives the greater tax is the one used.

The measure of the entire net income (or issued capital stock) within the state shall be such a portion of the entire net income (or entire issued capital stock), as the average value of such of the gross assets of the investment trust as consists of stocks, bonds and other securities located within the state bears to the average total value of such gross assets of the investment trust wherever located. The location of the assets of the trust is predicated, in part, on the location of the tangible assets of the issuer or obligor, the stocks or obligations of which are owned by the trust.

Records

It is essential that complete and accurate records be maintained of all transactions. The tax factor is of prime importance, particularly in the case of companies which are qualified as mutual investment companies. A clerical error might disqualify a company from enjoying the benefits of Sections 361 and 362

of the Revenue Act of 1938, with resultant increased taxation.

General

Lately your Committee has twice volunteered its services to the Securities and Exchange Commission—once, in connection with a proposed new form for registering investment contracts and securities of fixed investment trusts, and, again, on the Commission's contemplated report to Congress on the result of its study of investment companies and recommendations thereto. In the first instance, a conference was had with a representative of the Commission at which time the Committee was given to understand that its proposals would be given consideration. In the latter case a request was made for copies of the tentative draft of the report, so that the Committee could review the accounting aspects thereof and tender its comments thereon for consideration. A letter was received from the Commission thanking the Committee for its offer and expressing a spirit of cooperation.

Distributions on Capital Stocks

By THOMAS J. COGAN, C.P.A.

Accounting for distributions by corporations, the stocks of which are in the portfolio of the investment company, constitutes one of the important phases of investment trust accounting.

Corporate distributions may be discussed under three classifications:

(a) Dividends from earnings

(b) Capital distributions such as liquidating dividends

(c) Subscription rights received which although theoretically an invitation to additional investment may represent a return of capital when the recipient chooses to sell the rights rather than to exercise the subscription privilege

If asked why a dividend receipt constitutes income one might say that it is because it represents a distribution to the stockholder which leaves intact the equity in his investment, as it existed at date of acquisition. Of course in practice this is only approximately so, as distributions seldom are exactly equal to earnings.

Cash dividends from earnings meet this requirement and so there has been little question about the propriety of their being credited to income. However, in the case of dividends in the form of securities considerable question arises as to whether any income has been received by the investor.

Dividends paid in common stock of the paying company on common stocks held have been generally held by accountants not to constitute income since it is felt that there has been no distribution to the stockholder but merely a split-up of the shares representing the original investment. In other words the stockholder is practically in the same position as though no dividend action had been taken. This view has also been taken by the United States Supreme Court.

When dividends have been paid on common stocks in preferred stocks the position of accountants has not been as decided as in the case of common stock dividends. The following views have been held:

(a) That when no preferred stock was previously outstanding

the dividend represented only a reclassification of the stockholders' previously existing rights and not income

(b) If preferred stock was previously outstanding the dividend constitutes income as it results in a change in the previously existing rights of the stockholders

These views generally accord with the rulings by the courts in various tax cases.

Some corporations have paid optional stock dividends, i. e., dividends payable in cash or in stock at the holder's option. This practice has been undertaken recently in order to receive a "dividend-paid" credit under the provisions of the Revenue Act of 1936 as such dividends were held to be taxable to the recipients. However, where the terms of the payment are such that the market value of the stock is definitely greater than the amount of cash paid there would appear to be considerable question as to any distinction between such a dividend and an ordinary stock dividend.

There are some corporations which have paid dividends on preferred stock in preferred stock or in common stock. These dividends would seem to constitute proper income credits, since they result in increased equities to the recipients.

Another form of distribution is the so-called "in kind" dividend. In view of the many forms which such a distribution may take it is perhaps unsafe to generalize as to whether or not its receipt constitutes income. In most cases such dividends paid in securities or other assets owned by the corporation have been held by accountants to be income.

We now turn to capital distributions. These are of two general classes.

(a) Regular distributions which are made partly from funds provided through depletion reserves

(b) Distributions incident to the partial or complete liquidation of an enterprise

It would appear that the preferential manner of handling the first class of distribution would be to credit to income only that portion of the dividend which remains after providing for depletion.

Distributions in liquidation are usually credited to the cost of the investment to the extent of the amount of cash and fair value of property received. After full liquidating dividends have been received the remaining debit or credit balance in the investment account is charged or credited to profit and loss. Of course in many cases practically all the assets are received as part of the initial distributions leaving only a nominal value for the remaining equity. In such instances it would appear preferable to charge off the investment without waiting for the final distribution. Some accountants have taken the position that where liquidating distributions are chiefly in the form of "in kind" securities, the cost of the investment should be allocated to the securities received rather than taking such securities into the accounts at market values with a corresponding credit to the cost of investment in the company in process of liquidation. The effect of this treatment of course is to postpone the charge or credit to profit or loss until the securities received as liquidating dividends are disposed of. While the choice of method must of course depend to an extent upon the circumstances of a particular liquidation, it would appear generally preferable to credit liquidating dividends to cost of investments at market values for the following reasons:

(1) This method reflects the securities received in the accounts at current price levels

(2) This method coincides with the basis used for tax purposes

(3) Allocation of cost must be somewhat arbitrary particularly in cases of complete liquidations where a substantial part of the dividend usually is in cash. To "follow through" the theory of allocation of cost one should allocate a portion of the cost of investment to the cash received and record the differential as profit or loss. Just how much merit there would be to any such allocation is difficult to comprehend.

Subscription rights have been variously treated by accountants as:

(1) Credits to investment cost on the basis of allocating costs over the respective market values of the rights and the stock "ex-rights"

(2) Returns of capital to the extent of their fair market values (or proceeds from sale thereof)

(3) Income to the extent of their fair market values (or proceeds from sale thereof)

The first method has been most generally followed. It is based on the theory that the distribution of rights transfers to the rights a portion of the equity in net assets and earning power formerly represented by stockholdings and that a comparable portion of cost should be similarly transferred. This basis is also recognized for tax purposes.

The second method (crediting the fair market value of the right to the cost of investment) is based on the theory that the cost of the original investment represents in effect a "basket" the cost of any one of the contents of which is not ascertainable so that all proceeds received must be credited against the total cost until such cost is exhausted. This theory treats rights as being a partial liquidation of the stockholder's interest. While this in a sense is true when the rights are sold it does not necessarily follow that the portion of cost assignable to the interest disposed of cannot be ascertained. Unlike the case of a partial liquidation where a stockholder receives an asset "X" in his investment in company "Y" and cannot reasonably know what part of his cost of investment in "Y" was for that asset, the issuance of rights transfers a portion of his equity in all assets and in earning power to such rights. If he sells the rights it would appear that a quite definite percentage of his original investment has been disposed of and that profit or loss should be recognized.

The third method (crediting the fair market value of the rights to income) is based on the theory that the issuance of rights to subscribe to stock at less than its market value represents a distribution by the corporation of part of its surplus in the form of an opportunity to make an advantageous purchase. This method seems to have little to recommend it from an accounting standpoint. Granting that the issuance of rights is a kind of distribution of surplus the distribution of surplus would appear to be similar to a stock dividend and on this basis not a proper credit to income.

Discussion of Papers and Questions

After the presentation of the two papers, a lively discussion followed. Lack of space prohibits the publishing of the entire proceedings, but a number of the questions discussed and the answers thereto follow. It should be remembered that the answers represent opinions of only certain members of the Committee:

Question: Whether footnotes should be made to financial statements indicating realized profits or losses on sales of securities on the basis of average cost when such profits or losses were computed on a basis other than average cost, such as, first-in, first-out method or identified cost method?

Answer: If either the first-in, first-out method or the identified cost method is consistently used and the change during the period in net unrealized depreciation or appreciation of investments is shown in the financial statements it does not appear necessary to indicate what the realized profits or losses might have amounted to if computed on an average cost basis. If, however, there is an apparent attempt to distort profits or losses by using the identified cost method it would of course be necessary to point out such facts. The Securities and Exchange Commission has recently been taking exception to financial statements prepared on the basis of computing security profits and losses on the identified cost basis. In such cases they have required that footnotes be made to the financial statements indicating the profits or losses computed on an average cost basis. They have no doubt deemed the identified cost method to be objectionable because it is subject to manipulation whereas in the case of the other two bases mentioned this criticism cannot be made.

Question: Should realized security profits be credited to income, segregation of earned surplus account, or special reserve account?

Answer: In view of the fact that security profits are usually irregular and intermittent it appears preferable to credit such profits to a separate surplus account—a segregation of earned surplus. The Committee on Stock List of the New York Stock Exchange favors this treatment. Mr. Hoxsey, a former member of that Committee, has frequently expressed his opinion on the method of dealing with security profits as a special surplus item rather than as an item of income.

Question: In the case of open-end investment companies, would it not be preferable to discard the distinction between earned and capital surplus?

Answer: Since the open-end type of investment trust is constantly changing its capital structure by issuing shares at underlying net asset value and repurchasing its shares on a similar basis, it is practically impossible to distinguish between earned and capital surplus. At the present time it is the practice of such trusts to equalize undistributed net income from sources other than net security profits in respect of sales and repurchases of capital stock. The difference between par or stated value of capital stocks and the issue or repurchase price thereof after adjustment for equalization of income are credited or debited to capital surplus. While this is a practical solution to a difficult problem it does not however produce accurate results. Looking at the problem from the standpoint of capital and surplus, when a share of stock is purchased by an investor for an amount equal to underlying net asset value he is buying, in effect, a cross-

section of the net worth of the trust, namely:

1. Par or stated value of capital stock
2. Paid-in surplus
3. Net unrealized appreciation or depreciation of investments
4. Earned surplus:
   (a) Arising from sales of securities
   (b) Undistributed net income from sources other than security profits

Conversely, when a share of stock is repurchased from an investor the reverse situation is true in that the corporation pays a price equal to the per share amount of the aforestated elements.

It can readily be seen that in a period of advancing prices where larger security profits are realized or where there is a large amount of appreciation in the portfolio the price paid for shares by investors includes a large amount for such realized or unrealized profits. According to the method now followed by trusts an amount equal to such profits is credited to capital surplus. On the other hand, when shares are repurchased at a time when the market levels are low and there are consequent realized or unrealized losses on investments, it does not seem proper to charge capital surplus with the difference between par or stated value of capital and the repurchase price of such stock and to allow the difference between the average per share amount of capital surplus and such excess to remain in capital surplus account. The realized loss which might have been sustained in selling securities to obtain funds to liquidate such shares is charged against earned surplus. It might well be argued that the loss on that portion of the portfolio which relates to the retiring stockholders' interest might be charged against capital surplus since it tended to reduce the liquidating price of his shares.

Since equalization of all elements of capital and surplus is not feasible it would seem preferable not to attempt to distinguish between capital and earned surplus of these trusts, but rather, maintain only three sections of capital, namely:

1. Capital stock, at par or stated value
2. Surplus (to include capital surplus and security profits and losses)
3. Undistributed net income (exclusive of security profits and losses)

Question: Where market values are used, either parenthetically or as a valuation of assets in financial statements, should cost of realization, such as, stamp taxes, brokerage fees, etc., be taken into consideration?

Answer: Some trusts calculate costs of realization when computing asset value of their shares. However, in view of the fact that market quotations are merely an indication of values, it does not seem practicable to attempt to arrive at an exact liquidating value by taking into consideration relatively small items such as stamp taxes, brokerage commissions, etc. For practical purposes it seems sufficient to allow for only larger items such as federal income taxes on net appreciation and management fees which are payable upon realization of net appreciation.

Question: Where liquidating distributions on investments held are received in the form of securities of other companies, should the cost of the investments held be apportioned on the basis of market values, or should the market value of the se-

curity received be credited to the investment account?

Answer: Aside from situations meriting special treatment in view of particular circumstances it appears preferable to take up securities of other companies received as liquidating distributions on investments held at market value or estimated fair value at date of receipt and to credit the investment account in the issuing company with such value.

Question: Should preferred dividends received on common stock be credited to income under each of the following conditions:

(a) No preferred stock previously outstanding.

(b) When other preferred stocks were previously outstanding.

(c) Where preferred stock received is convertible into common stock.

Answer:

(a) No.

(b) Yes, but it would seem preferable to disclose such dividends which were not paid in cash.

(c) Yes, unless market price indicates possibility of immediate conversion.

Question:

(a) Should common stock dividends received on common stock be credited to income if such dividend is an optional stock dividend? Does it make any difference if the option for cash is unfavorable on a market value basis?

(b) Are common stock dividends on preferred stock, or preferred stock dividends on preferred stock, to be considered in the same category as common stock dividends on common stock, or as income?

Answer:

(a) No. There appears to be no difference as far as the stockholder is concerned between an optional stock dividend on which the cash option has not been exercised and a regular stock dividend. If the option for cash is unfavorable on a market value basis there seems to be less question as to the similarity of such dividends to regular stock dividends because the stockholders will undoubtedly choose the stock rather than the cash.

(b) Common stock dividends on preferred stock or preferred stock dividends on preferred stock represent income and are not in the category of regular common stock dividends on common stock.

Question: Where a subsidiary investment company is purchased at less than underlying asset value based on market quotations, should the underlying assets be reduced to so-called consolidated cost? What appropriate method might be suggested to accomplish this? Also answer this if the condition is the reverse.

Answer: In a consolidated statement all assets should be carried at cost to the consolidated companies. Therefore, the discount at which shares of a subsidiary have been acquired should be applied against the underlying assets of the subsidiary at date of acquisition. Since the assets other than securities are usually susceptible to valuation without much difficulty it would appear feasible to apply such discount pro-

portionately against the investments valued at market or estimated fair value at date of acquisition.

If there is an excess of purchase price over underlying net asset value of a subsidiary's shares acquired based on market quotations or estimated fair value and such excess purchase price cannot be attributed to intangibles or considered as cost of a large block of stock which perhaps has a fair value in excess of the current market price, it would seem that such excess cost should be charged off. Such situations are rather remote except in cases where relatively small minority interests are acquired.

Question: In computing minority interests in a consolidation of investment companies, should such minority interest be computed on the basis of the subsidiary companies' underlying asset values based on cost to the subsidiary or cost to the parent company?

Answer: The method of computing minority interests in a consolidated statement depends entirely on the method used in presenting such statements. If the statement is prepared on a market basis the minority interest should be computed on the same basis. Such computations should be based on the costs to the subsidiary in the case of a cost statement.

Question: Where securities are sold on one day at a profit and the same securities are repurchased the next day at the same or approximately at the same price, should a realized profit be recorded on such transaction, or should the securities be reinstated in the portfolio at original cost and the expense incident to the sale and repurchase of such securities be charged to income?

Answer: It appears more conservative to reinstate such repurchased securities at original cost and to charge off to income the expenses incident to such transactions. Another conservative method might be accorded such transactions by creating a surplus reserve for such profits which could be restored to earned surplus upon ultimate disposition of the repurchased securities. It does not seem proper for a company to treat such profits as realized if there was no intention of disposing of the securities involved in such transaction.

Question: Should not investment company balance sheets be prepared on the basis of current market quotations, or in the absence thereof, at estimated fair value with parenthetical notes as to the market value?

Answer: Statements prepared on the basis of market or estimated fair value appear preferable because the investor is primarily interested in the value of his investment. However, such statements should indicate parenthetically the costs of investments and the net unrealized appreciation or depreciation of investments should be shown as a segregation of surplus.

Question: Where securities are carried in the balance sheet at cost and no provision is made for net unrealized depreciation of investments (excess of cost over amount of securities priced at market quotations), should not a footnote be made on the balance sheet referring to surplus and indicating how much surplus would be reduced if a reserve for such depreciation were set up in the balance sheet?

Answer: In order that financial statements may not be misleading it is deemed essential that a footnote be made against either surplus or the aggregate of capital and surplus to indicate the effect of net unrealized depreciation of investments.

Question: Do dividends from realized security profits represent a return of capital if the portfolio securities have a market deprecia-

tion in excess of the realized security profits surplus?

Answer: It would seem that management would be subject to criticism if dividends were paid at a time when net unrealized depreciation of securities in portfolio offset the amount of earned surplus. However, if such dividends are paid it is difficult to see how an accountant can deviate from charging such dividends first against earned surplus even though there exists an unrealized loss.

Question: Why is it the practice of investment trusts to allocate operating expenses only against dividend and interest income? I find that in most instances the operating expenses also apply in part to profits on sales of securities. Would not an apportionment be more equitable?

Answer: As a general rule it is considered that the excess of income from dividends and interest over operating expenses of a trust represents the main source of income, and that security profits should be considered in the nature of a special or extraordinary profit, and therefore no attempt is made to allocate expenses other than federal income taxes which might be brought about directly through the security profits. Of course, some companies overcome the problem of allocating expenses by crediting security profits, as well as dividends and interest income, to the income account, and deducting all expenses from the total, but I think the trusts that do that are mainly of the more or less management type investment company, which should be differentiated from the investment trust type.

There are investment companies that deal with special situations and perhaps they cannot be characterized strictly as "trusts". They might go in for underwriting and special investments and perhaps obtain control of companies. In other words, they would look on income as not being restricted to yield from investments, but that it would include any other profits realized as result of trading, or as a result of sale of special enterprises which had been developed to the point where they could be disposed of profitably.

You will generally find that investment trusts like to look upon dividends and interest, less operating expenses, as their chief source of income. Security profits are usually segregated from income and either set aside as special reserves or credited directly to earned surplus (or a segregation thereof). Security losses are charged to the account to which the profits have been credited.

Question: Do dividends from realized security profits represent a return of capital if the portfolio securities have a market depreciation in excess of the realized security profits surplus? In other words, if you had earned surplus of $1,000,000.00 and had a shrinkage in your portfolio amounting to $1,000,000.00, would you say a dividend paid out of that earned surplus was a return of capital?

Answer: It is, in effect, a return of capital because the securities have shrunk in value so that their net assets have been reduced, and then they further reduce them by paying dividends.

There is a question, however, as to how fairly the market prices indicate the value of the securities. If you have a depressed market due to some catastrophe, the security values, based on market values, may be quite out of line. But that is all the more reason for conserving any profits they have realized.

This resolves itself into a question of management policy. If it is done, however, the accountant cannot do other than to report the dividend paid and charge it to surplus. How-

ever, it is good practice to charge any diminution first to the company's earned surplus to the extent thereof and any remaining portion of such debit to capital surplus. Capital surplus should not be charged while an earned surplus exists.

This question is really an inventory proposition, and sound management should not disregard a shrinkage or loss in the portfolio securities, when considering realized security profits. The two should be taken together from a management standpoint.

Question: In the determination of market values, what consideration is given to large blocks, and to the application of the "blockage" rule? Would it be proper to use book value for large blocks, if the management feels that that is closer to the value of the entire block?

Answer: As a matter of general practice, it is almost impossible to evaluate a large block other than by using the market quotation, and indicating that it has been used. It is true that if you have a quotation based on the sales of, say, 100 shares, you are valuing perhaps a 10,000 share lot on that basis, but ordinarily an accountant or management cannot arrive at a better valuation. It is not practicable to seek an appraiser every time a statement is issued.

If the management feels that book value is closer to the actual value than market quotations, in a statement where the assets are carried at cost with a parenthetical notation as to market quotations, or estimated fair value, such an item could be shown separately with the market value indicated and a note made to the balance sheet stating the management's opinion that market quotations are not indicative of the fair value of the asset.

Question: What chance do you think there might be that the S.E.C. would apply the "English theory" of treating capital losses strictly as such, and items of income strictly as such? In other words if there is a capital loss it goes against the capital account.

Answer: The S.E.C. is leaning more the other way, that losses should be charged to earned surplus to the extent of earned surplus, which would constitute the opposite view to that expressed in the question.

Question: In connection with realized security profits, isn't it custom rather than the irregularity of the transaction that leads to putting such items into surplus as special credits?

Answer: No, the reason is that such profits are more or less irregular, and a better practice would be to accumulate such profits in a special surplus account and not distribute them as dividends, so that they would be available as a reserve against future losses, thereby maintaining intact the capital of the corporation. If a corporation declares dividends out of its security profits as well as out of other income in profitable years, in a market decline, there would be no earned surplus remaining and security losses, or shrinkages would, in effect, impair capital.

The idea of crediting profits directly to surplus and excluding them from the income account is more or less following the lines of the English practice.

The procedure suggested is consistent with the practice relative to legal trust fund accounting and the legal concept that profits from sale of principal assets remain in the corpus of the trust and are not distributable to beneficiaries as income. The application of this concept to investment trust accounting would certainly incline to the segregation of surplus.

Question: In mutual investing companies, don't they often have what is called an "equalization fund"?

Answer: Yes, a majority of them do. The theory is that when an investor buys shares in an open-end trust, he is paying for a portion of undistributed net income. The accrued net income up to the date of his purchase is included in the price because he pays underlying net asset value. The amount paid by the investor is taken up by the corporation, and credited to capital stock or capital surplus, and there is transferred from the latter account an amount equivalent to the accrued net income at time of purchase. It is, in effect, like accrued interest on a bond purchased before the interest payment date. Upon repurchase of shares of capital stock, the reverse procedure is followed, so that the investor receives his share of the undistributed net income at the date of repurchase.

Question: If a dividend were paid in depreciated securities, would it be necessary to reflect that in any way in the income account? In other words, assuming you had 10,000 shares of stock which had cost $100 and were now worth $50, and you paid them out as a dividend in kind, are you required to reflect any part of the transaction in the income account?

Answer: There was a case of that kind where securities costing approximately $1,000,000.00 were distributed as a dividend in kind, but their market value was approximately $600,000.00. Surplus was charged with the cost of the securities distributed in kind and the value based on market quotations was indicated parenthetically. The transaction was considered as a distribution of income in the form of a security, and the depreciation of the security was not reflected in the income account.

Inventories and Receivables

of Department Stores, Instalment Houses, Chain Stores, and Other Retailers

A Statement by the Committee on Auditing Procedure of the American Institute of Accountants

Query: Is it practicable and reasonable to observe the taking of inventories and to communicate directly with debtors, as added auditing procedures in the examination of the financial statements of department stores, instalment houses, chain stores, and other retailers?

THE report of the American Institute of Accountants dealing with extensions of auditing procedure indicates that, where "practicable and reasonable," observation of the taking of inventories and direct communication with debtors are to be considered "generally accepted auditing procedures," meaning that they are normal, usual, or customary. The conjunction "and" is used; the procedures must be both practicable and reasonable. If they are both, their application cannot be avoided. Their omission under such circumstances necessitates a clear-cut exception.

On the other hand, if these procedures are not practicable and reasonable in the circumstances of a given engagement, and if the auditor has otherwise satisfied himself, he need make no exception or explanation in his report. Under such circumstances, however, if he prefers to do so, he may make any explanation he sees fit.

The primary meaning of "practicable" is:

"capable of being put into practice, done, or effected, especially with the available means or with reason or prudence."

The primary meaning of "reasonable" is:

"endowed with reason, or rational, having or exercising sound judgment, or sensible."

Rarely is a procedure impossible or incapable of being put into practice, but it seems that the auditor may view "practicable" in the light of "with the available means," or "with reason or prudence." The operations may be practicable, but they may *not* be reasonable, i. e., not "sensible" in the light of surrounding circumstances. Notwithstanding these refinements in meaning, it is believed that there will be very few cases in commerce and industry as a whole in which the procedures cannot be applied, to the extent that will afford such tests as the auditor, in the exercise of his judgment, determines to be reasonable.

In the case of the receivables of department stores, instalment houses, chain stores, and other retailers, there might be justifiable question as to the reasonableness of applying the positive form of confirmation, but it is believed that there is no question as to the practicability and reasonableness of applying the negative form of confirmation which requires no reply unless the recipient challenges the balance shown. When dealing with housewives, as is the case in department stores particularly, the negative form is more practicable than the positive, as it places the recipient definitely on notice that the creditor's books show a stated balance, and that the auditor assumes the correctness of that balance unless the debtor objects within reasonable time.

It is believed, therefore, that department stores, instalment houses, and others dealing with ultimate consumers are among the cases in which the application of the negative

form of direct communication with debtors, when carried out in the manner suggested in the bulletin, *Examination of Financial Statements,* is to be considered as compliance with "generally accepted auditing procedure."

There is a further distinction between the larger institutions with large masses of receivables which may run into tens of thousands of items and the smaller ones, because the very mass of the accounts requires more than ordinary division of duties affording opportunity for more effective internal control. Confirmation of receivables by a selective test, where the conditions justify it, is within the contemplation of the added procedures prescribed. As a rule, the larger the mass, the smaller the average amount, and the more effective the internal control, the smaller may be the percentage of confirmation; and in unusual cases quite a small percentage may well be proper.

As to the added procedures regarding inventories of department stores, instalment houses, chain stores, and other retailers, it is likewise believed to be practicable and reasonable for the auditor to participate by suitable observation at the time inventories are determined by physical count by the client, or to require physical tests of inventories to be made under his observation. The method, extent, and time of applying this extension of auditing procedure necessarily will vary with the circumstances, and the procedures will be undertaken in addition to the usual auditing tests and checks of the inventory accounts and records, with due consideration to the effectiveness of the internal check and control as applied not only to book records, but also to the procedure of taking physical inventories.

Here again there is a distinction between large institutions with a great number of branches and/or departments and the more compact or simple organizations, because the volume of transactions requires more than ordinary division of duties, affording opportunity for more effective internal control. In such cases, the observation or tests of physical inventories may well be limited to a relatively small number of branches or departments and the larger the number of branches or departments and the more effective the internal control, the smaller may be the percentage to be covered; and in unusual cases quite a small percentage may well be proper.

The auditor's purpose is to satisfy himself as to the credibility of the client's representations concerning inventories, but he does not hold himself out as an appraiser, valuer, or expert in materials. The auditor does not "take," "determine," or "supervise" the inventory. These operations are undertaken by management, antecedent to its primary representations concerning quantity, condition, and value of the inventories. The independent certified public accountant "observes" these procedures in his capacity as an auditor, for the purpose of satisfying himself as to the fairness of representations made by the client, but he does not, and should not in his ordinary capacity as auditor, make the original determination. Within these clear limitations, it is believed that observation of the taking of inventories of department stores, instalment houses, chain stores, and other retailers is "practicable and reasonable" and, therefore, to be considered "generally accepted auditing procedure."

There appears to be a question in the minds of some concerning the character of exceptions necessitated by the omission of the added procedures when their application is practicable and reasonable. When the auditor has been unable to satisfy himself concerning the *amount* of

inventories or receivables (or any other asset) stated in the accounts, he will continue, as in the past, to make a definite exception as to the amount. Moreover, where the added procedures prescribed in "Extensions of Auditing Procedure" are practicable and reasonable, if the auditor has not adopted them an exception is still required even though he may have satisfied himself by other means as to the fairness of the amount. What is the character of the exception in these circumstances?

The report, "Extensions of Auditing Procedure," clearly refers to several types of exceptions in the following language:

"Any exception should be expressed clearly and unequivocably as to whether it affects the scope of the work, any particular item in the financial statements, the soundness of the company's procedure (as regards either the books or the financial statements), or the consistency of accounting practices."

This leads to the obvious conclusion that when the added procedures are applicable and the auditor has not adopted them but has satisfied himself by other methods, his exception need cover only the omission of the procedures (affecting the scope of work), without calling into question the inherent fairness of the representations. On the other hand, were the auditor not satisfied, and were his exceptions so material or the scope of his examination so limited as to negate the expression of an opinion, he would limit his report to a statement of findings, and, if appropriate, say that the limitations, or exceptions, were such as to make it impossible to express an opinion concerning the fairness of the statements as a whole.

There follows a restatement of the standard short form of independent certified public accountant's report including a typical paragraph relating to the exception which should be made when (a) the added procedures are "practicable and reasonable," but (b) have not been applied, and (c) the auditor has otherwise satisfied himself:

"We have examined the balance-sheet of the XYZ Company as of blank date, and the statements of income and surplus for the fiscal year then ended, have reviewed the system of internal control and the accounting procedures of the company and, without making a detailed audit of the transactions, have examined or tested accounting records of the company and other supporting evidence, by methods and to the extent we deemed appropriate, except as stated in the following paragraph.

"Auditing tests and checks of accounts and records concerning accounts receivable and inventories have been made, but upon instructions of the company we have not applied the generally accepted auditing procedures of direct communication with debtors or attendance at the physical count of inventories; nor have physical tests of inventories been made under our observation.

"In our opinion, subject to the exception stated in the foregoing paragraph relating to the limitations of the scope of our examination, the accompanying balance-sheet and related statements of income and surplus present fairly the position of the XYZ Company at blank date, and the results of its operations for the fiscal year, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year."

It should be emphasized that the language in which the exceptions are stated above is to be regarded as typical and not as standard. Each accountant must feel free to state his exceptions in whatever form his judgment dictates.

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